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

National Association of Mutual Insurance Companies

June 2005

About the Study

- Purpose
  - Commissioned by NAMIC to evaluate the cost/benefits of the NAIC's proposed changes to the Model Audit Rule relating to reporting on internal controls
- Process
  - Survey of NAMIC members
  - Secondary research
- Content
  - Characteristics of P&C mutuals
  - Why non-public insurers are concerned about Title IV
  - Problems in financial reporting
    - Experiences of public companies
    - Experiences of insurers
  - Cost/benefit analysis
  - Conclusions

Highlights of the Study

The Costs of the Proposed Reforms Significantly Outweigh the Benefits to Mutuals

- The implementation cost of the NAIC's proposal is almost 8 times the estimated benefit level to mutuals, even when those benefits presume that all insolvency costs would be completely eliminated – which NAMIC does not believe to be possible.
- NAMIC survey: Costs for year 1 alone for mutuals will aggregate to $300 million, equal to the cost of all mutual insolvencies in the "post-Accreditation reform era" from 1992-2003 ($200 million of which is PIE Mutual).
- Overall, the increased costs approximate the same impact as if the industry's federal tax rates were to be increased by 24%; the impact is regressive, costing smaller companies twice as much as larger companies as a percentage of premium; furthermore, smaller companies will see much less cost reduction in successive years.
- Estimated 2nd year cost reductions range from 41% for larger companies, to only 14% for smaller companies. Factoring this in, the ongoing costs are still a multiple (5X) of the foreseeable benefits to mutuals.
- Extended to the entire U.S. insurance industry, first year implementation costs would be $1 billion, about the current cost of state insurance regulation, and more than the current budget of the SEC.

Highlights of the Study (cont'd)

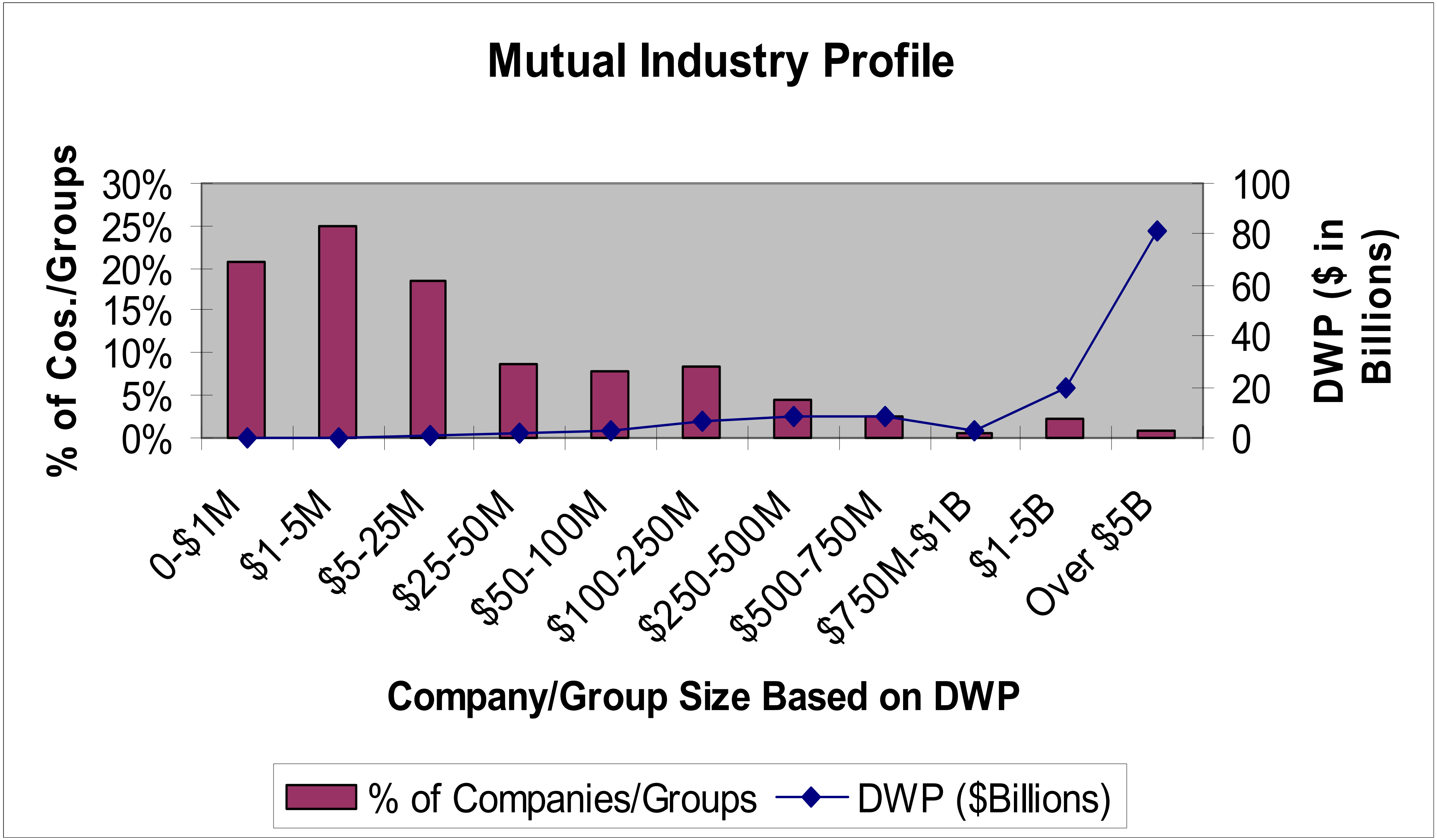
<u>The Existing Regulatory Model is Effective and Cost-Efficient for Mutuals</u>

- Mutual insolvency costs were 27% of total insolvency costs from 1977 through 1991.
- Since 1991, however, mutuals' share of total insolvency costs has only been 5% (***including PIE Mutual***) of the industry total, despite that mutuals represent over 33% of the total P&C insurance business during this period
- The changes resulting from the "Accreditation-reform" era reflected in current solvency regulation were clearly effective for mutuals, and have proven to be cost efficient – much more so than the current 404 proposal

Highlights of the Study (cont'd)

<u>The Real Benefits of 404 Impact Public Companies Only</u>

- The real benefits of §404 (minimizing the negative impact of reputational risk on stock values) inure to shareholders of publicly-traded companies; such benefits simply don't exist for non-public insurers or their policyholders.
- The nature and magnitude of incentives that pressure management of some public companies to intentionally misstate financial results or to "push the envelope" do not exist in the non-public insurer environment.
- Despite the hype about Enron and WorldCom, restatements and enforcement actions against public insurers have remained relatively small as compared to other industries and segments.
- The current proposal for §404-like practices is not necessary for mutuals.



Source: AM Best Data

The Main Issue: Title IV

- SOX intended to apply to public companies
- Key components proposed for inclusion in the MAR as “best practices”
  - Governance
  - Auditor Independence
  - Management’s report on internal control over financial reporting, and the independent auditor’s opinions thereon
- Cost/Benefit Analysis
  - A prudent first step to consider regulatory change
  - Embraced by the federal government since the 1970s

Feedback From Public Companies: The Good…

- Improved transparency; financial reporting quality; cost of capital; shareholder returns
- Improved governance, tone at the top
- Audit committees are stronger, more independent
- Auditors are more independent; improved communications with audit committees
- Better focus on the company's risks
- Improved awareness of controls/ responsibilities

We believe these benefits are largely attributed to market conditions and sections of SOX <u>other than</u> §404

…The Bad…

2004 Public Company Experience	Feedback – Desired Changes*
Transaction level focus	Top-down; entity level focus
COSO is the only model	Flexible approaches for smaller companies
High coverage ratios; checklist approach	Risk-based
High degree of "mind-share"	Balance with other strategic/business needs
Duplicative processes	Integrated audit
Inadequate guidance, especially for filers	More/better rules; principles-based
Obsession with IT controls	More guidance for compensating controls
Little reliance on mgmt., internal audit	More reliance, less duplication
Counterproductive auditor-mgmt. relations	Direct & timely communications

** Topics highlighted in yellow were addressed in PCAOB guidance issued May 16, 2005*

…and The Ugly.

SOX "drives up large companies' audit costs by $1.4 billion…"

"costs averaged $4.36 million…"

"…a total of $5.5 billion spent in 2004…"

"94% say the costs exceed the benefits"

Foreign and small filers will further exacerbate the resource shortage, much less the needs of non-public entities.

Internal controls still can't be relied upon to prevent fraud or intentional misstatements, especially if involving collusion or senior management.

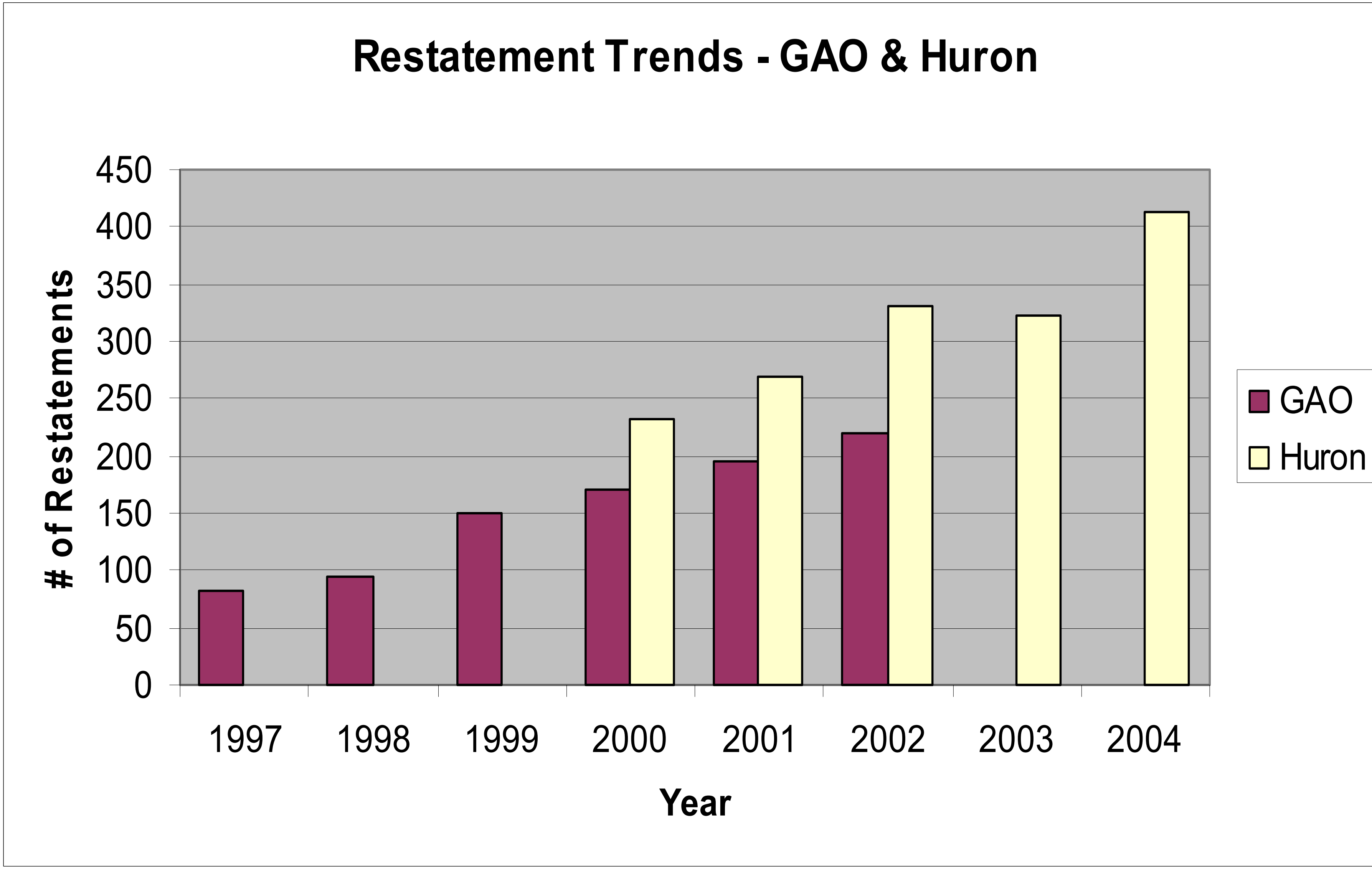
Problems in Financial Reporting: Experience of Public Companies

- The catalyst behind SOX and the NAIC's proposal
- Much has been said about Enron, WorldCom, etc.
- Much less about problems specific to insurers, and related implications to proposed NAIC/state reforms
- Sources of information:
  - SEC Enforcement actions
  - Restatements
- Key points from the experience of public companies

GAO Study on Restatements

- Studied 919 restatements involving accounting irregularities by 845 public companies from 1/1/97 through 6/30/2002
- The number of such restatements rose each year, and the number involving large companies (>$10 billion in market cap) grew rapidly
- 10% of companies restated during the study period
- On average, restatements caused a 10% drop in stock price, or about $100 billion in market capitalization

GAO: "the pressures on executives and boards of public companies to grow profitably and raise market values, combined with compensation arrangements, can create 'perverse incentives' to manage earnings, disguise risks, and avoid transparency…"



Source: GAO Report, Financial Statement Restatements, October 2002; and Huron Consulting Group

Insurance Restatements – 1997 Through June 2002

Line of Business	Date	Primary Issues	Previously Reported S/H Equity ($ in thousands)	% Change on Equity
Health	1997	PPO; goodwill; restructuring charges	101,456	11.14%
Heatlh	1997	Rent expense	2,740	-4.34%
Health	1997	Reserves and claims expense	128,510	-1.01%
Life	1997	DAC; reserves; purchase accounting	844,999	-1.85%
P&C	1998	Reserves and premiums	367,903	-16.19%
P&C	1999	Purchase accounting	349,443	-0.11%
P&C	1999	Reinsurance transfer of risk	308,349	-3.57%
Health	1999	N/A		N/A
Fin'l Guaranty	1999	Forward share purchase agreements	1,072,736	-0.68%
Title	2000	Adopted SAB 101	871,591	-6.38%
P&C	2000	Settlement with reinsurer	492,252	-0.79%
Health	2000	Sale of a business segment; other	11,305,900	0.09%
Health	2000	Break out discontinued ops; other	606,226	-8.53%
P&C	2001	Tax accounting	27,559	-2.36%
Reinsurance	2001	Finite reinsurance; FAS 133 adoption	265,546	-0.69%
P&C	2001	N/A		N/A
P&C	2001	N/A		N/A
		Weighted average % change		-1.12%

N/A = Not apparent or data not available

Accounting and Auditing Enforcement Release Activity

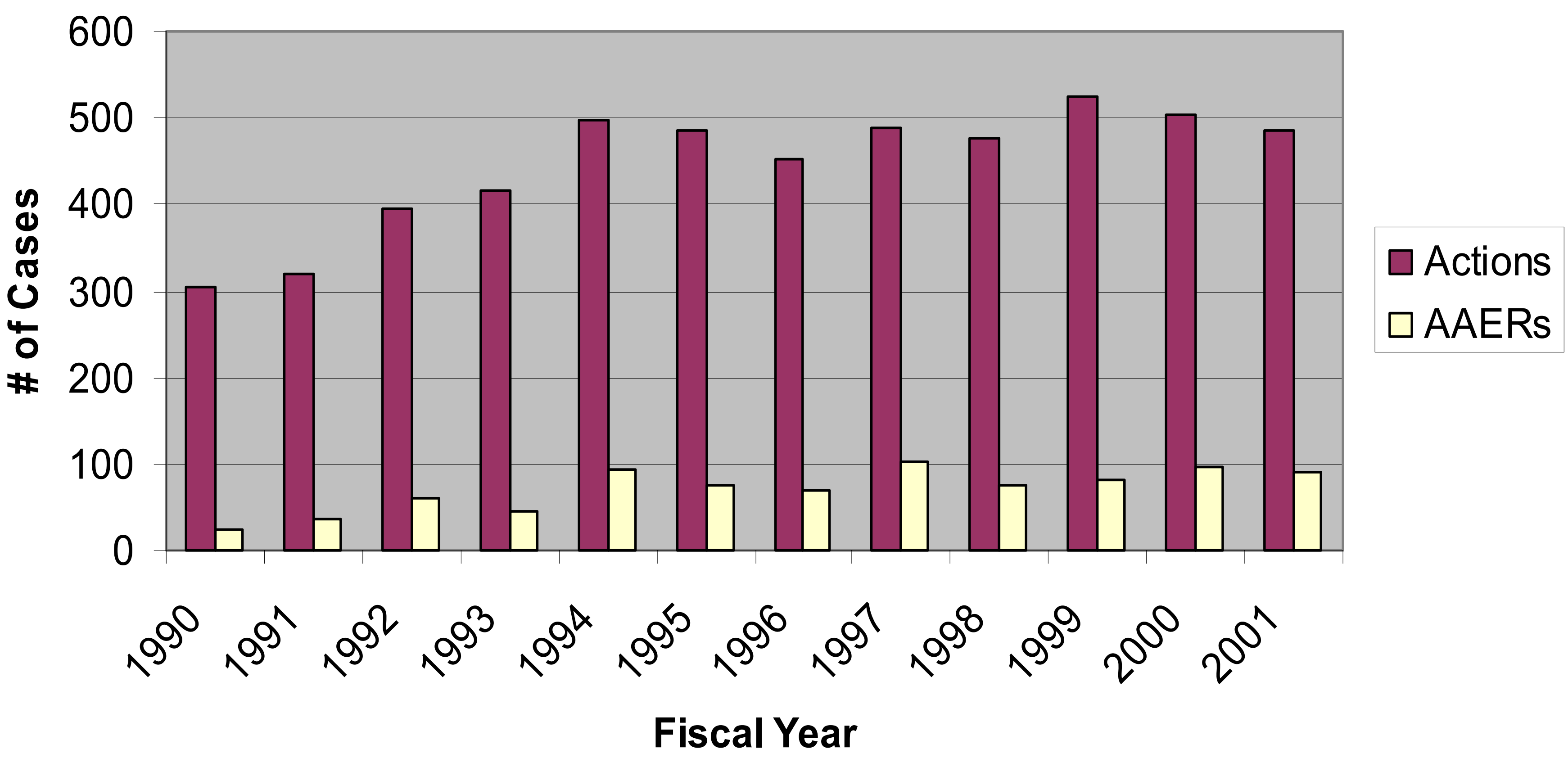
<u>COSO/Treadway Comm. Report on Fraudulent Financial Reporting</u>

- Reviewed 204 financial reporting enforcement actions from 1987-1997
- Primary cause of misstatement: improper revenue recognition (50% of the cases studied); typical characteristics:
  - Small companies; weak audit committees; financial pressures
  - Boards dominated by insiders; large % of stock owned by board members
- The CEO and/or the CFO were implicated in 83% of the cases

<u>SEC Report Pursuant to SOA§704</u>

- Covered 5 years preceding SOX, and areas most susceptible to fraud, inappropriate manipulation, or earnings management
- Studied 515 enforcement actions arising out of 227 investigations related to 164 entities, half of which were charged with fraud
- Only 6 insurance-related cases occurred during the study period
- In 75% of the cases, charges were brought against a board chairman, CEO, President, CFO, COO, CAO, or VP of Finance

GAO: SEC Enforcement Actions and AAERs



Note: "AAER" stands for Accounting and Auditing Enforcement Releases, Issued by the Securities and Exchange Commission

Source: GAO Report, Financial Statement Restatements, October 2002

AAERs Relating to Insurer Financial Misstatements: 1990-2005 YTD

<u>Life & Health</u>

- 1992 – Small annuity writer (<$200 million in equity); improper reporting in 1989 for other than temporary declines in value of high yield securities
- 1994 – Life segment of large multi-line insurer; improper reporting and disclosures when adopting FAS 97 in 1988 and 1989
- 1994 – Transmark USA; wash sales in period from 1986-1989, and lack of disclosure of violations of statutory investment limitations
- 1994 – First Capitol Holdings; reinsurance bolstered equity in 1990 by $74 million, but did not meet statutory requirements
- 1995 – Small insurer: lack of appropriate disclosure of related party transactions, and source of funds backing an acquisition
- 1995 – Life segment of large multi-line insurer; failure to disclose relationship with real estate developer and risks for $187 million of loans
- 2002 – Mid-size health insurer; $81 million error in recording revenue in 1997, and related failure to restate (s/h equity at the time was $650 mm)
- 2004 – Large life & annuity writer; failure to write down investments, and inappropriate "top-side" adjustments

AAERs Relating to Insurer Financial Misstatements: 1990-2005 YTD

P&C:

- 1994 –Reliance Group Holdings; $39 million overstatement of investment gains due to wash sales in 1986
- 1997 – Misstatement of reserve liabilities in 1992 and 1993 filings by a small surety writer
- 2000 – Small title insurer (<$20 million in assets); assets overstated by 10-18% due to improper accounting for investments in affiliates in 1994 and 1995
- 2003 & 2004 – 3 cases where 2 very large financial institutions sold certain products to help their customers improve their reported financial position; $246 million in aggregate fines and penalties

Key Points From the Experiences of Accelerated Filers

- Restatements have been rising
- Enforcement actions have been more focused on technology companies
- Top execs were implicated in over 75% reporting improprieties
- Inherent limitations on the ability to prevent fraud, particularly when willing senior managers act in collusion; transaction-level control documentation of marginal value in these situations, but improved governance can help
- P&C insurers are a very small portion of total restatements or enforcement actions over a very extended timeframe

There are no apparent pattern or magnitude of restatements or enforcement actions that suggest systemic problems for public insurers, or that would suggest pervasive concerns about financial reporting involving non-public insurers

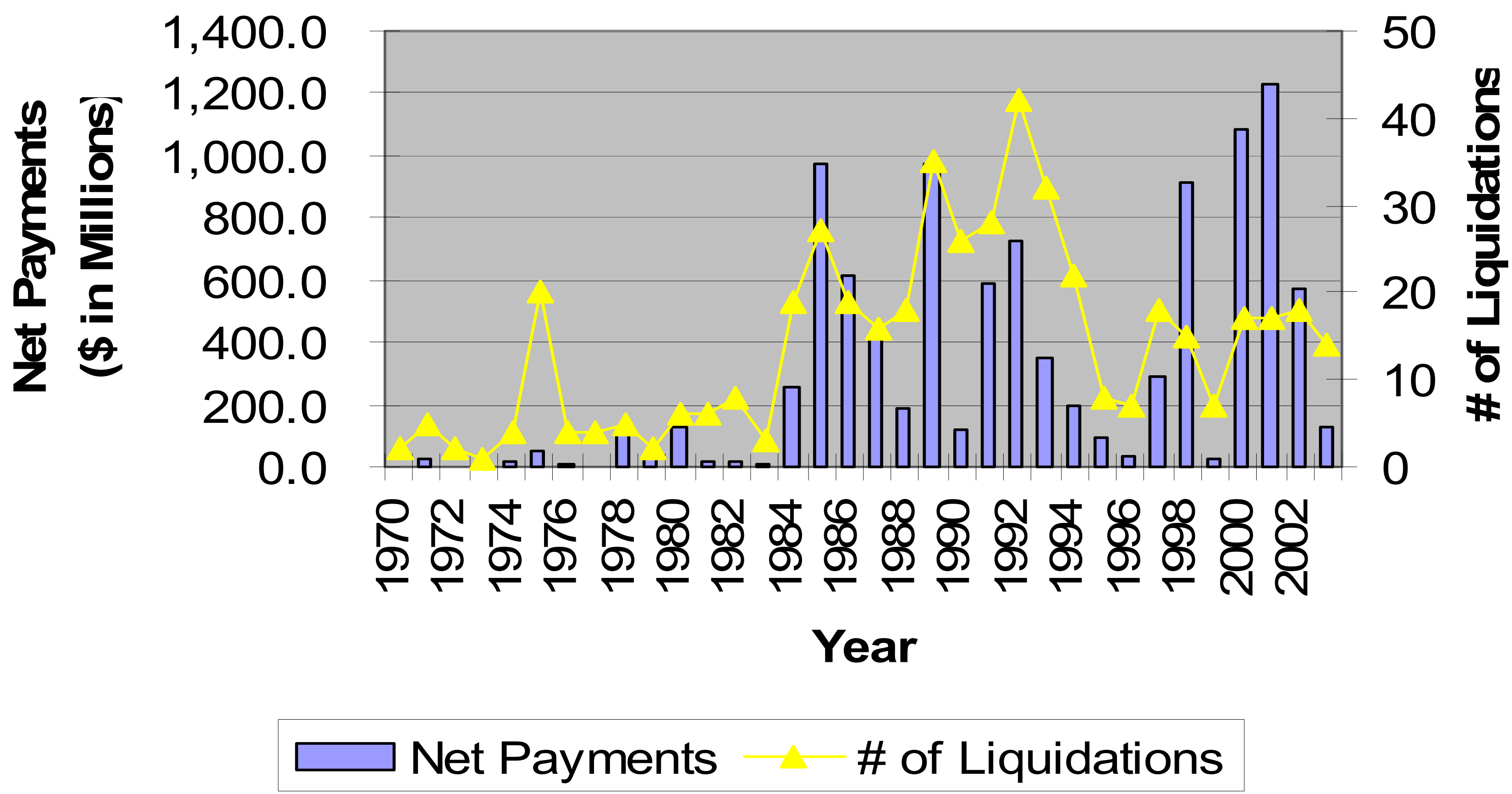
Insolvency Experience of P&C Insurers

- A.M. Best studies on insolvencies:1969-1990; updated through 2004
- On average, mutuals were 45% of the companies in the industry over that time frame, but comprised only16% of the financially impaired companies in the A.M. Best study
- Mutuals have not been as active in the more volatile commercial and casualty lines, relative to other types of insurers
- Greater demands have been placed on managers of stock companies by shareholders
  - Keep capital highly utilized
  - Can lead to higher degrees of underwriting leverage
- Typical characteristics of financially impaired companies:
  - Over 95% had less than $50 million in policyholder surplus
  - Over 50% were incorporated for less than 15 years
  - Over 80% experienced unusual growth in premium income

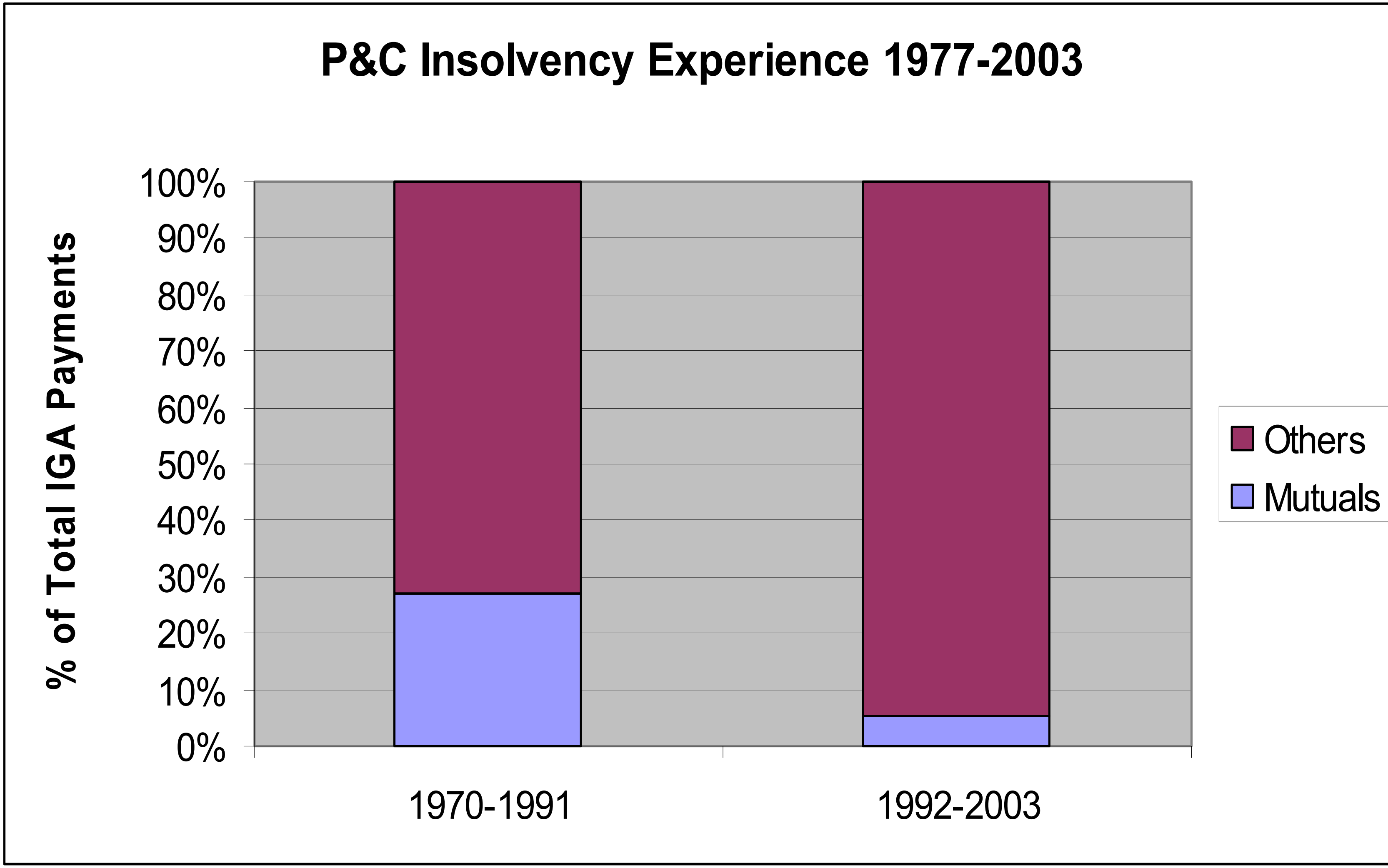
P&C Insolvency Experience

- Principal causal factors: deficient loss reserves (54%) and fraud (16%)
- Net post-assessment costs through 2003: $10 billion
- Insolvency experience is very highly correlated to underwriting cycles; deteriorating financial conditions triggered the end of each soft market, followed by a rise in insolvencies
- 3 periods of high insolvencies: 1975; 1984-1993; 2000-2002.
- From severity perspective, worst years were 1985 (53 companies, including Mission, Transit Casualty, Iowa National) and 2001 (Reliance)
- Limitations on data
  - Includes only cost of claims covered by IGAs

IGA Activity by Liquidation Date



Source: National Conference of Insurance Guaranty Funds



Source: National Conference of Insurance Guaranty Funds

Top 20 P&C Insolvencies

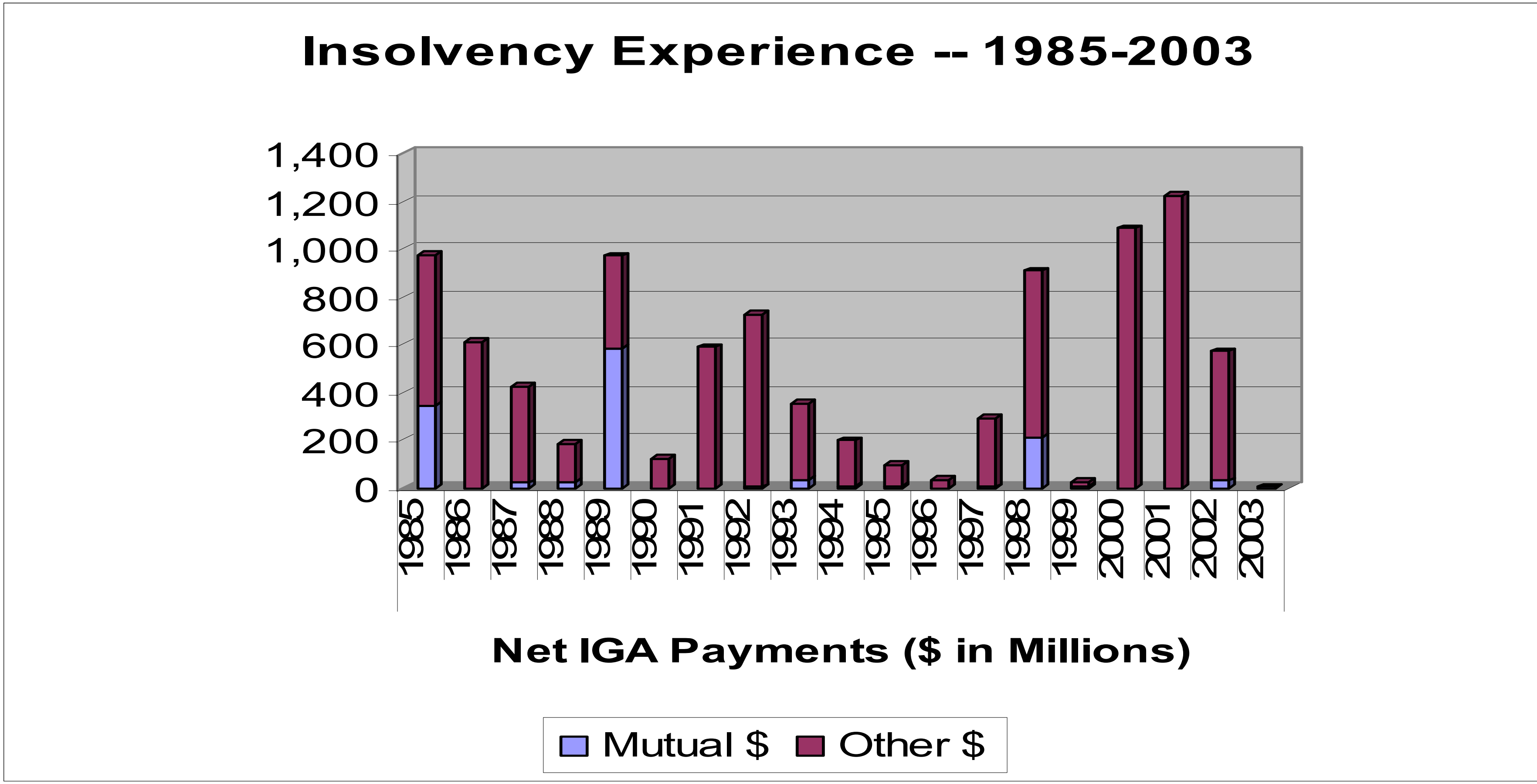
Liquidation Date	Company Name	Net Payments	
2001	**Reliance Insurance Company**	$708	6.7%
2000	**California Compensation Insurance Company**	559	5.3%
1986	**Midland Insurance Company**	455	4.3%
1989	**American Mutual Liability Insurance Company**	324	3.1%
1985	**Ideal Mutual Insurance Company**	291	2.8%
2002	**PHICO Insurance Company**	283	2.7%
2000	**Superior National Insurance Company**	261	2.5%
1989	**American Mutual Insurance Company of Boston**	239	2.3%
2003	**Legion Insurance Company**	225	2.1%
1985	**Transit Casualty Insurance Company**	225	2.1%
1989	**Champion Insurance Company**	213	2.0%
1987	**Integrity Insurance Company**	212	2.0%
1985	**Union Indemnity Insurance Company of NY**	209	2.0%
1998	**First Central Insurance Company**	208	2.0%
1991	**Texas Employers Insurance Association**	205	1.9%
1998	**PIC Insurance Group, Inc**	203	1.9%
2001	**Credit General Insurance Company**	190	1.8%
1998	**PIE Mutual Insurance Company**	181	1.7%
2001	**HIH American Compensation & Liability Ins. Co.**	179	1.7%
1998	**NY Merchant Bakers Insurance**	175	1.7%
		5,545	52.4%
	All others, aggregated	5,035	47.6%
	Total net payments through 2003	$10,580	100.0%

Source: National Conference of Insurance Guaranty Funds

Largest Mutual Insolvencies

Liquidation Date	Company Name	Net Payments	
1989	**American Mutual Liability Insurance Company**	$324	21.0%
1985	**Ideal Mutual Insurance Company**	291	18.8%
1989	**American Mutual Insurance Company of Boston**	239	15.5%
1998	**PIE Mutual Insurance Company**	181	11.7%
1980	**Cosmopolitan Mutual Insurance Company**	117	7.6%
1978	**Consolidated Mutual Insurance**	91	5.9%
1985	**Iowa National Mutual Insurance Company**	49	3.2%
		1,292	83.6%
		253	16.4%
		$1,545	100.0%

Source: National Conference of Insurance Guaranty Funds



Mutuals have comprised 1/3 of industry premium, but only 5% of total P&C insolvency costs over the 1992-2003 timeframe (only 2% if PIE Mutual were excluded). A need for §404-like provisions for mutuals is not indicated.

Source: National Conference of Insurance Guaranty Funds

Cost Analysis

- Industry surveys
  - FEI
  - Big-4
  - Other Insurance Industry Reports
  - FERF
- NAMIC survey

FEI Survey

- Average compliance costs:
  - $1.34 MM –- internal costs
  - $1.72 MM –- external costs
  - $1.30 MM –- auditor's fees
  - $4.36 MM –- total for year one

- The 404 audit fees are in addition to the financial statement audit fees, on average 57% higher (that % increases in reverse proportion to company size, ranging from 48% for the largest companies, to 65% for companies with revenue under $500MM
- Cost as a % of revenues declines as revenues increase. On a relative basis, it is much more expensive for a company with only $50 million in revenues to adopt the requirements v. a company with $3 billion in revenues
- Smaller companies have substantially less internal audit hours that can be devoted to the effort; more work has to come from financial staff with other responsibilities
- 85% of respondents expect non-auditor costs to decline in year 2 by 39%
- 68% of respondents expect auditors costs to decline in year 2 by an average of 26%; the rest felt that such costs would remain the same or increase
- 94% of companies surveyed believe that 404 costs far exceeded the benefits

Big-4 Survey

- Big-4 firms jointly commissioned Charles River Associates to survey 90 clients from Fortune 1000
- Average revenue - $8.1 billion; Average compliance cost -- $7.8 million; ratio -- .10%
- 25% of costs were for §404 audit fees
- Average of 271 control deficiencies (some of which possibly would have been classified as significant deficiencies or material weaknesses) per company were identified and remediated in 2004
- An average of an additional 77 deficiencies are expected to be remediated in 2005, 96% of which are neither significant deficiencies nor material weaknesses
- An aggregate of 5 material weaknesses were unremediated at the year-end assessment date across the 90 companies surveyed
- Total year 2 costs are expected to decline by 46%

NAMIC Survey – Response Rates

Strata	Surveys Sent	Responses Received	Response Rate %	Groups	Single Companies
Less than $25 mm	10	2	N/A		
$25-99 mm	65	22	33.85%	8	14
$100-249 mm	32	15	46.88%	9	6
$250-499 mm	16	8	50.00%	7	1
$500-999 mm	15	7	46.67%	7	
$1 bill and over	9	4	44.44%	4	
Total Evaluated (> $25mm):	147	56	40.88%	35	21

NAMIC Survey – Internal Costs

Strata	Internal Audit	Accounting & Finance	Other	Total
$1 billion and over	$3,037,500	$1,875,000	$5,196,000	$10,108,500
$500-999 mm	142,871	249,014	422,543	814,429
$250-499 mm	214,375	166,875	162,500	543,750
$100-249 mm	76,357	84,714	141,714	302,786
$25-99 mm	34,205	45,568	15,909	95,682

NAMIC Survey: Expectations for Year 2 Internal Costs

Strata	Internal Audit	Accounting & Finance	Other	Total Internal Costs
$1 billion and over	-44%	-58%	-41%	-45%
$500-999 mm	-25%	-33%	-40%	-35%
$250-499 mm	-41%	-38%	-25%	-35%
$100-249 mm	-3%	-11%	-17%	-12%
$25-99 mm	-10%	-13%	-24%	-14%

NAMIC Survey: External Costs

Strata	External Audit	Consulting Fees	Software & IT	Total
$1 billion and over	$2,825,000	$0	$625,000	$3,450,000
$500-999 mm	432,857	471,429	51,429	955,714
$250-499 mm	160,000	315,000	75,625	550,625
$100-249 mm	98,333	126,667	60,667	285,667
$25-99 mm	45,386	29,773	28,750	103,909

NAMIC Survey: Expectations for Year 2 External Costs

Strata	External Audit	Consulting Fees	Software & IT	Total External Costs
$1 billion and over	-4%	0%	-38%	-10%
$500-999 mm	-10%	-46%	-48%	-30%
$250-499 mm	-21%	-65%	-32%	-48%
$100-249 mm	-5%	-32%	-20%	-20%
$25-99 mm	-1%	-33%	-18%	-15%

NAMIC Survey: Expectations for Year 2 Total Costs

Strata	Internal	External	Total
$1 billion and over	-45%	-10%	-36%
$500-999 mm	-35%	-30%	-32%
$250-499 mm	-35%	-48%	-41%
$100-249 mm	-12%	-20%	-16%
$25-99 mm	-14%	-15%	-14%

NAMIC Survey: Average FTE Headcounts

Strata	Acctg. & Finance	Internal Audit
$1 billion and over	404.0	104.3
$500-999 mm	42.0	4.3
$250-499 mm	14.9	2.4
$100-249 mm	9.9	0.4
$25-99 mm	5.4	0.3

NAMIC Survey: Summary

	Average Cost Per Company				($ in Millions)	
					Est. 2005 Mutual	Est. 404 Cost for
Strata	Internal	External	Total	% of DW&AP	Premiums	Mutuals
$1 billion and over	$10,108,500	$3,450,000	$13,558,500	0.183%	$106,971	$196
$500-999 mm	814,429	955,714	1,770,143	0.239%	12,155	29
$250-499 mm	543,750	550,625	1,094,375	0.352%	9,072	32
$100-249 mm	302,786	285,667	588,452	0.364%	7,293	27
$25-99 mm	95,682	103,909	199,591	0.384%	4,981	19
Less than $25 mm					1,756	
					$142,227	$302

“To what extent do you believe the costs outweigh the benefits…?”

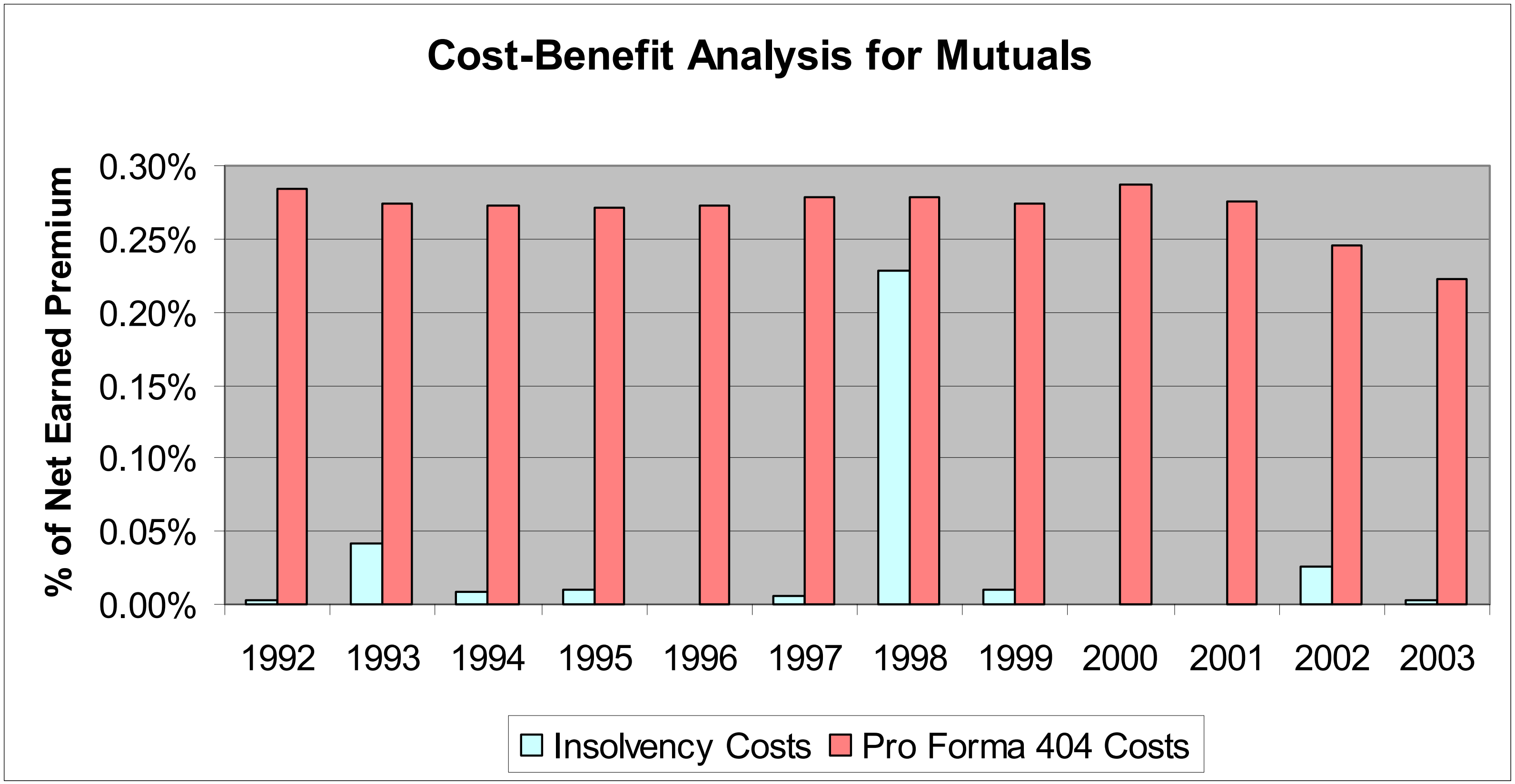
Strata	None	Minimally	Moderately	Significantly
$1 billion and over	0.0%	0.0%	25.0%	75.0%
$500-999 mm	0.0%	14.3%	0.0%	85.7%
$250-499 mm	0.0%	25.0%	0.0%	75.0%
$100-249 mm	0.0%	13.3%	13.3%	73.3%
$25-99 mm	4.8%	4.8%	28.6%	61.9%
Overall - NAMIC	1.8%	10.9%	16.4%	70.9%

Net Cost-Benefit for Public Companies: Congressman Oxley

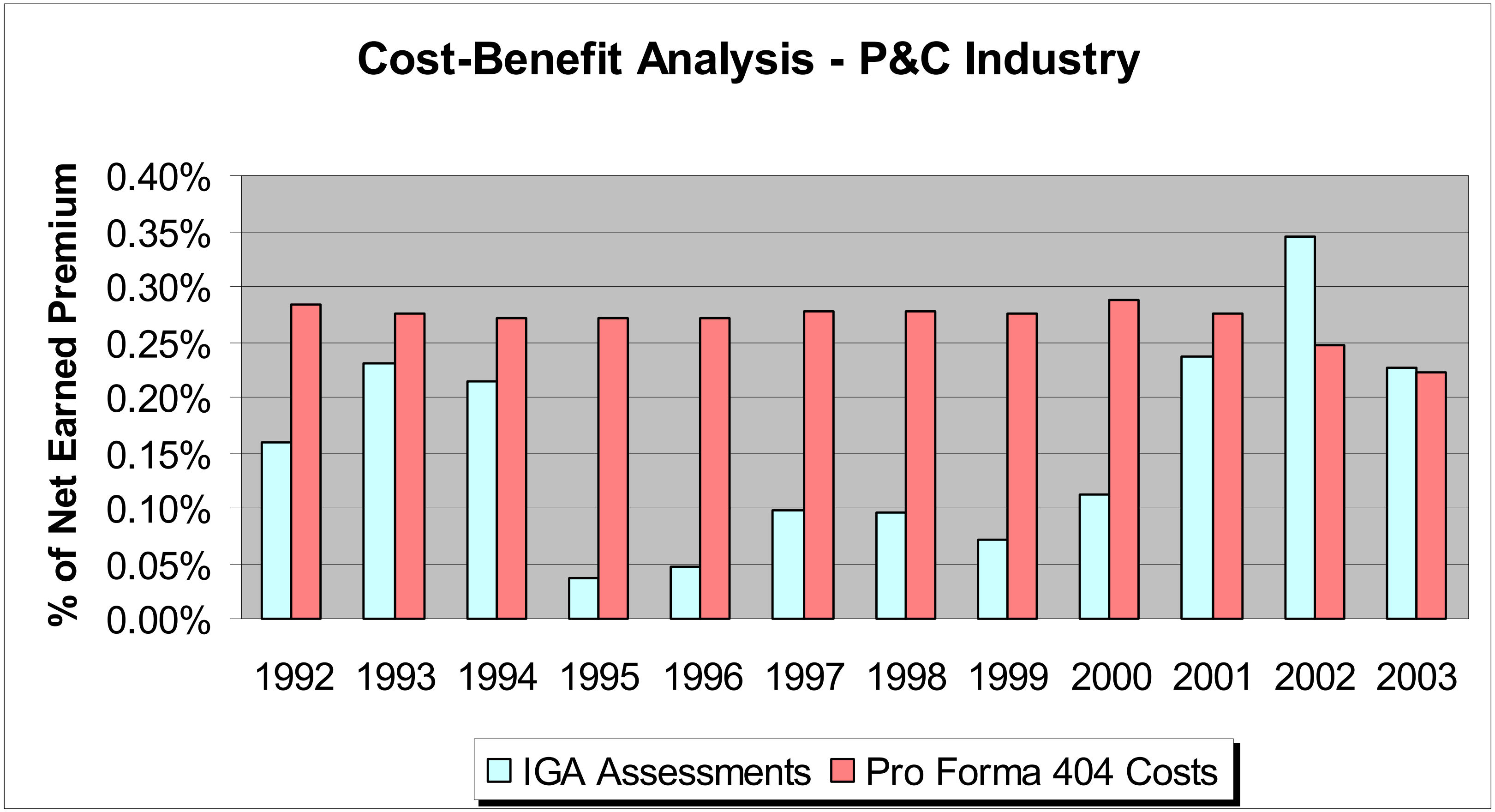
- The benefit of SOX is the loss of market value that will be avoided
  - $ 67 billion for Enron
  - $161 billion for WorldCom
- That's worth the cost of compliance, even for companies that have told us that they may spend as much as $300 million
- "How can you measure the value of knowing that company books are sounder than they were before? ...the outlays now are a small fraction of the losses that were sustained."

Non-public insurers have no comparable measure as market cap; they don't produce paper gains and don't risk any such losses. So, the loss of market value that can be avoided by non-publics through 404 is ***zero****.*

Pro-Forma Analysis of Estimated Implementation Costs - Mutuals



Pro-Forma Analysis of Estimated Implementation Costs – All P&C



Summary of Key Points

- 404 will cost mutuals $300 million to implement; they will decline some after year 1, but will remain a significant and permanent addition to insurers' cost structures
- Under either a Year-1 or Year-2 scenario, the costs will be a multiple of the most optimistic estimate of benefits
- Insolvency data for mutuals has been very favorable and suggests that the accreditation-related reforms were very effective for this segment of the industry
- Because insolvency data for mutuals is so favorable, the hoped-for benefits are low. Much of the benefits of SOX and 404 apply only to publicly-traded companies, whereas non-publics would have all the same costs (and perhaps more).
- 94% of mutual groups have <15 accounting and finance FTEs, on average
- Valid concerns continue to exist with 404; despite the PCAOB's new guidance, practices will continue to evolve and even public companies will face a new learning curve; the favorable insolvency cost data for mutuals indicates that there is no apparent need for mutuals to rush to the "bleeding edge" of that learning curve
- Public insurer enforcement actions and restatements do not suggest any pervasive systemic problems with spill-over effect to non-publics
- Most financial reporting scandals involve senior management and collusion; internal controls can't be relied upon to prevent such cases
- 98% of respondents feel the costs outweigh the benefits

Public Policy Considerations

- NAMIC's research validates a $1 billion price tag for the industry – P&C, life, and health combined
- Approximates the current total cost of state insurance regulation
  - Budgets of state DOIs
  - NAIC budget
- Exceeds the SEC's current budget
- To recoup the additional costs, mutuals alone would have to sell:
  - 11 million more policies for the first year
  - 7.4 million more in year 2 to cover recurring costs
- Cost notwithstanding, the current proposal will exacerbate the current dire shortage of qualified resources

Policy Recommendations

- We all have a shared interest in insurance company solvency
- Undertake a 3-step evaluation:
  - Study in detail the causes and effects of insurer insolvencies
  - Examine existing financial regulations/laws to determine shortcomings, if any
  - Develop targeted, cost-effective remedies to address 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.
- In the meantime, companies will be free to adopt provisions of the Act voluntarily, as indeed many have.

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