Competitive Enterprise Institute

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Honorable Joseph Torti, III
Rhode Island Superintendent of Insurance
Chair, NAIC Financial Regulation Standards and Accreditation "F" Committee
233 Richmond Street
Providence, RI 02903

Re: Model Audit Rule

Dear Superintendent Torti and members of the "F" Committee:

I write to you on the behalf of the Competitive Enterprise Institute, a Washington, D.C.-based think tank devoted to liberal economic policies. We advocate these policies because we believe in freedom for both individuals and business enterprises. We believe that the economic deregulation we advocate will benefit the economy and the American people as a whole.

In this context, we believe that the NAIC should not adopt the proposed new Model Audit Rule (MAR) as an accreditation standard under any circumstances and, in fact, should consider undertaking advocacy efforts to exempt all insurance companies—investor-owned and mutual alike—from the strictures of Sarbanes-Oxley. This letter addresses four issues:

- Sarbanes-Oxley, the chief inspiration for MAR, has damaged America's financial markets without boosting investor confidence. In short, it has failed.
- Regardless of structure, insurance companies already subject themselves to rigorous financial oversight from all fifty states, the District of Columbia, and other American possessions. In many important ways, the MAR would simply duplicate this oversight while creating opportunities for error and fraud.
- Mutual and investor-owned insurance companies have the same fundamental structure and business objectives. It follows that NAIC and other regulatory bodies should subject them to oversight that is the same in all important respects.

We believe that a shift towards the use of market mechanisms will do a better job providing necessary regulation than would a further extension of Sarbanes-Oxley.

- ***Therefore, we believe that the NAIC should both avoid adopting the MAR as an accreditation standard* and *engage in advocacy to exempt all investor-owned insurers from most existing provisions of Sarbanes-Oxley.***

Sarbanes-Oxley Has Failed

The MAR, as proposed, would apply significant parts of the Public Company Accounting Reform and Investor Protection Act of 2002, best known as the Sarbanes-Oxley Law, to mutual insurers. In particular, it implements Sarbanes-Oxley-like mandates that companies work to maintain the independence of their auditors, review their internal controls, and have these internal controls themselves monitored. Doing these things, we believe, impose significant costs but lack clear offsetting benefits. Some companies in some industries may find the specific control mechanisms in Sarbanes-Oxley useful. Some investors may prefer to purchase companies that use them. On balance, however, the law has not done any good for the economy.

No substantial evidence exists that Sarbanes-Oxley improved the operation of the public investor-owned companies it seeks to regulate or increased investor confidence. At least one major public company, Fannie Mae, has experienced a major accounting scandal in its wake.

The law's implementation, however, coincides with a significant drop in the number of initial public offerings taking place in the United States relative to the number taking place in the United Kingdom and elsewhere. While the number of IPOs taking place on the New York Stock Exchange exceeded the number in on the London Stock Exchange prior to Sarbanes Oxley, the number on the LSE has increased steadily since the law went into effect.[1] The Hong Kong Stock Exchange, likewise, has maintained its lead over any American exchange and the percentage of IPOs taking place in the U.S. has dropped an all-time low as a percentage of the world's dollar volume.[2] The LSE—the largest European stock exchange--in fact, has taken to running advertisements in major international hub airports advertising the UK economy's own freedom from Sarbanes-Oxley.

While Sarbanes-Oxley has imposed significant costs on public companies and reduced the dynamicism of the American economy, it has done nothing to improve investor confidence. Markets—as measured by the S&P 500 and NASDAQ composite averages--actually dropped in the immediate wake of its approval and did not recover until other positive economic indicators emerged.[3] One leading scholar summarizes the consequences of Sarbanes-Oxley as follows:

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[1] "Interim Report of the Committee on Capital Markets Regulation." Committee on Capital Markets Regulation, November 30, 2006.

[2] Ibid, 8.

[3] Peter J. Wallison. "Sarbanes-Oxley as an Inside-the-Beltway Phenomenon," AEI Financial Services Outlook, February, 2005.

> The cumulative abnormal return around all legislative events leading to the passage of the Act is significantly negative. The loss in total market value around the most significant rulemaking events amounts to $1.4 trillion. [4]

The same scholar outlines significant costs for companies across the board. One poll of financial executives at 224 public firms revealed that the average firm would have to spend nearly $3 million to just comply with the law's single most onerous section (section 404, which the MAR replicates in its important aspects.)[5] Given that insurance companies have some of the most complex financial statements around, one can only expect that their costs, on average, will prove even higher. We are told, in fact, that the NAIC's own examination of the costs of an earlier draft of the MAR indicated that the law's costs would outweigh its benefits 8 to 1. While the proposed MAR has been revised to take these costs into account, we do not know of any cost-benefit analysis on the newly-revised rule. We urge that the NAIC, at minimum, undertake one.

Whatever the costs, however, somebody will have to pay them. In many cases, we expect that policy holders will do so in the form of higher premiums and lower-quality service.

Current Financial Control Regulation Is Adequate

This seems unnecessary because insurance, of course, already ranks among the most tightly regulated industries in the country. All sizeable insurers, investor-owned, mutual, and reciprocal, furthermore, already have formal internal control systems. The NAIC itself has encouraged the adaptation of uniform, stringent solvency regulation throughout the nation.

Whatever its flaws, this system of 50-plus-state solvency regulation has proved successful in preventing insolvency. According to A.M. Best and Company, despite record-setting catastrophic losses in recent years the percentage of financially impaired companies has actually followed a downward course since 2000 despite 2005's $7.3 billion underwriting loss.[6] It has been decades since a major insurer has failed or experienced accounting problems that threatened its ability to survive as a going concern. Just last month, indeed, A.M. Best reported that property/casualty firms reported their lowest combined ratio since 1948.[7] All insurance companies that have failed in the last five years, as best as our review can determine, have been smaller enterprises to which

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[4] Ivy Xiying Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," University of Rochester, February 2005.
http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf

[5] Financial Executives International, July 2004

[6] Carol Anne King and John Williams, "2007 Annual Property and Casualty Impairments," A.M. Best and Company, March 26, 2007.

[7] A.M. Best and Company. "P/C Industry Reports Record-Setting Underwriting Profit for 2006, Reports Lowest Combined Ratio Since 1948," April 23, 2007.

the model audit rule would not apply. While accounting problems at Enron, Adelphia, WorldComm and other companies created the environment for Sarbanes-Oxley, no similar situation exists in the insurance industry. The industry is healthy, profitable and, according to its leading news source, over 99.5 percent of all companies are financially sound. [8]

Whatever its flaws—and CEI believes they are significant—this existing system of political oversight does not lack for rigor. Unlike private audit firms, which can only ask for data, governmental solvency regulators can demand it. Unlike private firms, these regulators can exact both civil and criminal penalties when companies fail to supply timely, accurate information. The MAR would require insurers to recompile much of the same information already made available to these state regulators. The work of recompiling similar data in different forms could, we believe, lead to risk for error and, perhaps, increased opportunities for fraud.

The primary architect of the Sarbanes-Oxley law, Rep. Michael Oxley, indeed, has said that he did not envision his law being applied to highly regulated financial institutions like banks and insurance companies. Speaking about his own law, he told a leading financial publication:

> It is a highly regulatory regime [intended for banks] that is superimposed on publicly traded companies. So, banks ended up with the worst of all worlds — existing banking regulations and [Sarbanes-Oxley]. I even discussed exempting regulated financial institutions, but I didn't win.[9]

We believe that the existing system of solvency regulations results in higher policy premiums, lower returns to shareholders, and smaller policy dividends than would a system that relied less on government oversight. The adaptation of the MAR would only add another level of regulation to an already cumbersome system.

More Government Regulation is not the Answer

All economic activity requires regulation of one sort or another. We approach most governmental regulation with great suspicion. But we believe that regulatory standards ought to be the same for similarly situated parties. We believe that mutual insurance companies and investor-owned ones are in a fundamentally similar situation.

Let us provide a few examples. Like mutual insurance policy holders, investors ought to have an interest in the price and quality of the products the companies they own offer. Mutual policy holders, likewise, have an interest in the dividend income they receive just as investors have an interest in the returns they receive. Insurance companies of all sizes and ownership structures must maintain reserves that may differ from the reserve needs of companies in other lines of business. Although they do not seek profits

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[8] Ibid.

[9] Stephen Taub. "Oxley: I'm Not Happy with Sarbox," CFO Magazine via CFO.com http://www.cfo.com/printable/article.cfm/8985156/c_2984368?f=options, April 6, 2007.

as such, mutual companies that seek to remain in business cannot operate as charities: they must make wise investments with their premium income and maintain sound underwriting standards. Nearly all sizeable mutual companies seek year-over-year growth just like profit-making companies. Finally, both mutual and investor-owned companies compete for the same customers.

Thus, investor-owned companies would make a valid point if they were to contend that being subject to Sarbanes-Oxley places them at a competitive disadvantage relative to their mutual counterparts. The solution to this problem, however, is not to subject mutual companies to the same strictures as their investor-owned counterparts but, rather, to both reject the MAR *and* work to exempt investor owned companies from Sarbanes-Oxley.

The NAIC Should Work to Exempt all Insurers from Sarbanes-Oxley

Quite simply, even if they were good ideas for the economy as a whole, neither Sarbanes-Oxley nor the Model Audit Rule would fit the needs of the insurance industry or, for that matter, any other heavily regulated industry. They duplicate regulation that already exists.

If existing solvency regulation does not prove sufficient to meet the NAIC's goals with regard to the financial stability of insurance companies, it should focus on improving that regulation rather than adding another, duplicative set of regulatory burdens.

Instead, it should engage in policy making activities and carry out public advocacy activities that would create a free and open market for all players in all insurance markets throughout the nation. Such activity would improve the functioning of America's risk transfer system and redound to the benefit of the economy as a whole.

In closing, on behalf of the Competitive Enterprise Institute, I thank the NAIC for the opportunity to submit testimony.

Respectfully Submitted,

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