Approved March 26, 1991
Date

MINUTES OF THE House COMMITTEE ON Insurance.

The meeting was called to order by Representative Turnquist at
Chairperson

3:30 xxxx/p.m. on Monday, March 25, 1991 in room 531 N of the Capitol.

All members were present except:
Tom Sawyer - Excused
Henry Helgerson - Excused

Committee staff present:

Bill Edds, Revisor
Chris Courtwright, Research
Gena Lott, Intern
Nikki Feuerborn, Secretary

Conferees appearing before the committee:

Dick Brock, Insurance Commissioner's Officer
Dave Hanson, NAII

Others Attending: See attached list

Representative Neufeld moved for the approval of the minutes for the March 21, 1991, meeting. Representative Welshimer seconded the motion. Motion carried.

Hearing on SB 53 - Examination of Insurance Companies - NAIC

Chris Courtwright of Research gave a brief explanation of the bill. This is part of a package of three bills recommended by the Insurance Commissioner to assist the Kansas Insurance Department in its efforts to be accredited by the National Association of Insurance Commissioners. Accreditation would indicate that Kansas has in place the essential statutes, regulations, and resources necessary for adequate solvency regulations.

Dick Brock of the Insurance Commissioner's staff testified as a proponent of SB 53. This bill deals with the examination of insurance companies and other entities regulated by the department such as risk pools, health maintenance organizations, prepaid service plans, etc. These are the on-site audits conducted by the field examiners with respect to financial condition examinations and by members of the Topeka-based staff with respect to performance audits of market behavior. The primary amendments proposed relate to financial condition examinations. This will would add the provisions for Kansas law to coincide with the new model law on examinations. Each proposed change was reviewed and explained by Mr. Brock. A balloon amendment was proposed to satisfy the Kansas Society of Certified Public Accountants as the current language might permit the Commissioner to examine work products and papers otherwise protected under a client privilege. (See Attachment 1).

David Hanson, representing NAII, appeared in support of Mr. Brock's testimony.

There were no opponents to the bill and the hearing was declared closed.

Representative Neufeld moved for the adoption of the balloon amendment to SB 53. Representative Flower seconded the motion. Motion carried.

Representative Campbell moved for favorable passage of the bill as amended. Representative Welshimer seconded the motion. Motion carried.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

CONTINUATION SHEET

MINUTES OF THE House COMMITTEE ON Insurance,

room 531-N, Statehouse, at 3:30 xxx/p.m. on Monday, March 25, 1991.

SB 67 - An act relating to insurance and insurance holding company systems.

Chris Courtwright of Research gave an overview of the bill. This bill was recommended by the Insurance Commissioner to update Kansas law by incorporating recent National Association of Insurance Commissioners' (NAIC) amendments to its model insurance holding company act. Kansas had enacted the original model with some amendments in 1974. This bill is part of the package necessary to be accredited by NAIC.

Dick Brock of the Insurance Commissioner's staff appeared as a proponent of SB 67. This bill is intended to update Kansas law by incorporating NAIC amendments in order to exercise some regulatory control over acquisitions, mergers and other holding company transactions not addressed in current statutes. The bill and the present NAIC model include provisions allowing access to assets of a parent or controlling interest in a holding company system in the event of insolvency of an insurance affiliate; provides for penalties and sanctions that are more compatible with regulatory needs; and, several amendments requiring more information to be provided the Commissioner. Mr. Brock reviewed the proposed changes (See Attachment 2) and stated that the adoption of the bill will fulfill a definite regulatory need and serve the public interest as well as assist in accreditation.

Discussion by the committee included the striking of lines 6-19 on Page 9 of the bill as it allows the Insurance Department to change Kansas statute with rules and regulations rather than amendments. Mr. Brock said this provision had never been used since its adoption in 1974 but it would be a convenience if the department ever felt it was mandatory.

There were no opponents to the bill and the hearing was declared closed.

SB 111 - An act relating to the supervision, liquidation, and rehabilitation of insurance companies

Chris Courtwright of Research gave an overview and history of the bill which is part of the Insurance Commissioner's proposed package to become accredited by the NAIC. This bill would establish the general application, definition, and jurisdiction of the act as well as providing rules for coordination and uniform action among the states in dealing with insolvent insurance companies.

Dick Brock of the Insurance Commissioner's staff, testified as a proponent of the bill. This bill is a blueprint of the formal legal procedures to be followed in dealing with an insurance company that is in financial difficult. The bill is divided into four sections: general provision, summary actions, formal proceedings, and interstate relations. Mr. Brock summarized and gave the purpose and advantages of each section. A balloon amendment which would permit setoffs except where the same business is being ceded and assumed is proposed. (See Attachment 3).

The meeting was adjourned at 4:45 p.m.

# GUEST LIST

COMMITTEE: Insurance DATE: March 25, 1991

| NAME (PLEASE PRINT) | ADDRESS | COMPANY/ORGANIZATION |
|---|---|---|
| Dick Brock | Topeka | Ins Dept |
| LaVerne Schneider | " | HIAA |
| Nancy Zogleman | " | BC/BS of Ks |
| Jim Oliver | " | PIAK |
| [illegible] | Topeka | Ins Dept |
| Susan Somers | Topeka | KSCPA |
| Dave Hanson | Topeka | NAII & Ks Insur Assocs |
| J.C. [illegible] | Topeka | KSCPA |
| Ron Smith | " | KS Bar |
| Larry Magill | " | IIAK |
| Shusten Turnquist | | |
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Testimony By

Dick Brock, Kansas Insurance Department

Before the House Insurance Committee

Senate Bill No. 53

March 25, 1991

As the members of this committee have no doubt observed through media coverage, congressional activity and general concerns or discussions about the economy, the financial health and solvency of various kinds of financial institutions is increasingly being called into question. The savings and loan crisis, the alarming number of bank failure and an unacceptable increase in the number of insurance company insolvencies have all contributed to this uncomfortable business environment.

From an insurance regulatory perspective, many of the dire predictions are completely groundless and others are an exaggeration of the real situation. Nevertheless, individual insurance departments, through the National Association of Insurance Commissioners (NAIC), have embarked on an intensive and unprecedented effort to strengthen insurance solvency regulation in all jurisdictions.

Specifically, the NAIC has adopted a program which consists of a set of standards that identify the essential statutes, regulations and resources necessary for adequate solvency regulation. In addition to adoption of the standards, this NAIC initiative is supplemented by an independent accreditation program whereby each state will ultimately be evaluated to determine if the laws, regulations and resources meet the standards established.

This is a new program. Just last month the first two states were accredited -- New York and Florida -- but the other states, including Kansas, are working toward that goal. As a result, legislative proposals dealing with solvency regulation are a primary focus of the department's

House Insurance
March 25, 1991
Attachment 1

1991 legislative recommendations. These are Senate Bills 53, 67, and Senate Bill No. 111.

With the enactment of these bills and the adoption of an administrative regulation relating to reinsurance agreements entered into by life insurance companies, Kansas will be in a position to request accreditation.

With that preface and a reminder that this introduction applies to all three of the bills you are hearing today, I will address the significant amendments proposed by Senate Bill No. 53 and the reason therefor.

Senate Bill No. 53 deals with the examination of insurance companies and other entities regulated by the Department such as risk pools, health maintenance organizations, prepaid service plans etc. These are the on-site audits conducted by our field examiners with respect to financial condition examinations and by members of our Topeka based staff with respect to performance audits of market behavior.

The primary amendments proposed by Senate Bill No. 53 relate to financial condition examinations and we have so specified when appropriate. For example, the reference to the examiners' handbook adopted by the National Association of Insurance Commissioners in Section 2(b) of the bill relates to a handbook and procedures specifically directed toward financial condition examinations. This handbook would not be appropriate and, in fact, it would probably not be possible to attempt to relate the criteria Section 2(b) relates to market conduct examinations. These amendments are a result of a year-long study of the financial condition examination system employed by the insurance departments of the several states. This study involved five public hearings held in Salt Lake City, Phoenix, Orlando, Chicago, Boston and Kansas City conducted by a special

committee of the National Association of Insurance Commissioners. At these hearings, conferees included insurance commissioners, insurance department examiners, representatives of insurance companies, various trade associations, and CPA firms all of whom were encouraged to present candid observations and constructive suggestions with regard to changes in the examination process that would make it more effective and more efficient. From this input, 17 specific recommendations emerged including a new model law on examinations. Our current law already effectively contains many of the provisions of the new model so rather than propose enactment of the complete new model in, Senate Bill No. 53 simply adds the provisions or makes the changes necessary for our law to coincide.

By incorporating these changes we will not dramatically change the way Kansas administers or conducts examinations. This is particularly true with respect to the time lines imposed for preparing and processing the examination report. Under current law, even without these time lines, our examination reports are almost always prepared, processed and released within the periods imposed by this proposal. However, this is not true of all states and we, as does every other state, to a great extent depend on the examination reports from other states with respect to insurers not domiciled in our state. Consequently, these time frames are included in the model and the model is included in the NAIC's financial regulation standards for the purpose of accelerating the availability of examination findings to all states, which obviously includes many states that already produce examination findings quickly. However, if Kansas supports a recommendation which will hopefully require a state that does not now produce examination reports in a timely fashion, we should, must be, and are willing to impose the same requirements upon ourselves.

With that background, a section by section presentation on the proposed amendments follows:

New Section 1. -- This is the definitions section none of which have a particularly unique meaning but all of which are necessary to add clarity to the subsequent provisions.

Section 2. -- (a) The amendment in this subsection re-inserts a periodic examination requirement. While examination laws should permit the Commissioner to direct examination resources to areas of greatest need as opposed to a purely calendar type of scheduling, some periodic review is necessary to avoid situations when financial condition could deteriorate over a period of time because of a lack of regulatory oversight.

(b) This is a new provision which will produce more efficient use of examination resources by application of criteria that will match examination needs and processes with the general financial condition of the company to be examined.

(c) This is current law and no amendments are involved.

(d) This subsection makes it clear that the authority to examine an insurance company is not limited to the company itself if some other entity such as a managing general agent exercises significant operational control or is in possession of pertinent accounting or other records of the company.

(e) The new language in this subsection restricts the Commissioner's acceptance of examination reports on foreign or alien companies to those conducted by or under the supervision of an accredited insurance

department. This is a quality control mechanism that will become operational on and after January 1, 1994.

(f) In order that financial condition examinations will be performed in a consistent manner and therefore produce a consistent result from state to state, the significant part of this amendment is the new provision which requires the Commissioner to follow the procedures set forth in the NAIC examiner's handbook. This provision does, however, permit the Commissioner to utilize other procedures that might be more thorough in given situations.

(g) This is a new subsection which authorizes the Commissioner to revoke or suspend an insurer's certificate of authority if its officers, directors, employees or agents do not submit to examination and cooperate with examiners.

(h) This subsection permits the Commissioner to employ any necessary special expertise and include the cost of such expertise in the costs of examination to be paid by the company.

(i) This new provision makes it clear that the Commissioner is not required to complete an examination and prepare a formal report of examination prior to pursuing any regulatory action otherwise applicable under Kansas law. The original bill also declared examination findings to be prima facie evidence in any legal proceeding which, in effect, placed the burden on the examined company of proving that such findings were incorrect or invalid. As a result of objections raised during testimony and because the provision is not of great important, the Senate Committee struck the language appearing in lines 14-16 on page 3.

(j) This subsection will specifically permit the Commissioner to use a report of examination as soon as and to the extent necessary to pursue any legal or regulatory responsibility.

(k) This subsection, including subparagraphs (1) through (7), establishes various time periods within which the various stages of processing an examination report are to be completed. In addition, this subsection contains the permits and limitations relating to release of the examination report, disclosure of its content and disposition of work papers, documents, affidavits and other pertinent background information accumulated during the course of the examination.

The next to last amendments to the existing law are necessary to avoid a duplication or conflict of statutory provisions because of the new, more specific provisions relating to the examination report.

The final amendment is in recognition of Senate Bill No. 111 which consists of a new Liquidation and Rehabilitation law. If such law is enacted, this amendment will prevent a duplication or conflict. If it is not enacted, this amendment will still be harmless because the only way the Department can begin action to dissolve a company is through the Attorney General.

Section 3. -- This is the repealer section.

Section 4. -- This is the effective date section and proposes an effective date of January 1, 1992 because amendments to the NAIC Examiners Handbook that will complement the appropriate provisions of this act are not scheduled for adoption until September of this year and our examiners need some time to familiarize themselves with the new procedures.

Subsequent to Senate passage of the bill, a concern was raised by the Kansas Society of Certified Public Accountants regarding Section 2(d) on page 2 of the bill. Specifically, it was feared that the current language might permit the Commissioner to examine work products and papers otherwise protected under a client privilege. To alleviate this fear, we developed the proposed balloon amendment attached to my testimony and the "Society" has agreed that this additional language adequately addresses their concern.

1 (c) For the purpose of such examination, the commissioner of
2 insurance or the persons appointed by the commissioner, for the
3 purpose of making such examination shall have free access to the
4 books and papers of any such company that relate to its business
5 and to the books and papers kept by any of its agents and may
6 examine under oath, which the commissioner or the persons ap-
7 pointed by the commissioner are empowered to administer, the
8 directors, officers, agents or employees of any such company in
9 relation to its affairs, transactions and condition.
10 *(d) The commissioner may also examine or investigate any person,*
11 *or the business of any person, in so far as such examination or*
12 *investigation is, in the sole discretion of the commissioner, necessary*
13 *or material to the examination of the company.* ~~.~~ but such examination or investigation shall not infringe upon or extend to any communications or information accorded privileged or confidential status under any other laws of this state.
14 *(e)* In lieu of examining a foreign *or alien* insurance company,
15 the commissioner of insurance may accept the report of the exam-
16 ination made by or upon the authority of ~~the supervising insurance~~
17 ~~official of any other state.~~ *the company's state of domicile or port-*
18 *of-entry state until January 1, 1994. Thereafter, such reports as they*
19 *relate to financial condition may only be accepted if:*
20 *(1) The insurance department conducting the examination was at*
21 *the time of the examination accredited under the national association*
22 *of insurance commissioners' financial regulation standards and ac-*
23 *creditation program; or*
24 *(2) the examination is performed under the supervision of an*
25 *accredited insurance department, or with the participation of one*
26 *or more examiners who are employed by such an accredited insur-*
27 *ance department and who after a review of the examination work*
28 *papers and report state under oath that the examination was per-*
29 *formed in a manner consistent with the standards and procedures*
30 *required by their insurance department.*
31 *(f) Upon determining that an examination should be conducted,*
32 *the commissioner or the commissioner's designee shall appoint one*
33 *or more examiners to perform the examination and instruct them as*
34 *to the scope of the examination. In conducting an examination of*
35 *financial condition, the examiner shall observe those guidelines and*
36 *procedures set forth in the examiners' handbook adopted by the*
37 *national association of insurance commissioners. The commissioner*
38 *may also employ such other guidelines or procedures as the com-*
39 *missioner may deem appropriate.*
40 *(g) The refusal of any company, by its officers, directors, em-*
41 *ployees or agents, to submit to examination or to comply with any*
42 *reasonable written request of the examiners shall be grounds for*
43 *suspension or refusal of, or nonrenewal of any license or authority*

A. Laws and Regulations

**OK 1. Examination Authority**

The department should have authority to examine companies whenever it is deemed necessary. Such authority should include complete access to the company's books and records and, if necessary, the records of any affiliated company, agent, and/or managing general agent. Such authority should extend to not only to inspect books and records but also to examine officers, employees and agents of the company under oath when deemed necessary with respect to transactions directly or indirectly related to the company under examination.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regualtion which satifies the standard on examination authority? | **XXX** | |
| b) Cite the law or regulation. **K.S.A 40-222** | | |
| c) Does the department's examination authority apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas code satifies the standard on examination of authority***

A new model examinations law was adopted by the NAIC in December 1990. At the same meeting, such model was added to the Financial Regulation Standards. As a result, our current examination authority no longer satisfies this standard. 1991 Senate Bill No. 53 will bring Kansas back into compliance.

## 2. Capital and Surplus Requirement

**OK** The department should have the ability to require that insurers have and maintain a minimum level of capital and surplus to transact business.

The department should have the authority to require additional capital and surplus based upon the type, volume and nature of insurance business transacted.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on capital and surplus requirements? | **XXX** | |
| b) Cite the law or regulation. **KSA 40-901,1102, 1103, 401, 402, 1204, 1210, 1001,3503, 222b** | | |
| c) Does the law or regulation require capital and surplus at organization to be in the form of cash and/or marketable securities? | **XXX** | |
| d) Does the department's authority to require minimum levels of capital and surplus based upon the type, volume, and nature of insurance business transacted apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | | **XXX** |
| e) If further explanation is required to amplify the above responses, please use the space below **HMO's are excluded from the minimum capitalization requirements** | | |

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we were not asked for cite on 2d part of this std. Therefore, the comment is not germane. We meet the standard.

***from Detailed Review***

***s code sections cited do not specifically give the department authority to require capital and surplus based on the type, volume and nature of insurance business d.***

Response: True, however, KSA 40-222b(4) states " require a contribution to surplus which will : company's surplus an amount, and in such a manner, as the commissioner may deem necessary and essential;

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***Comments from Detailed Review***

***The code sections cited do not specifically say that the capital and surplus at organization be in the form of cash and/or marketable securities.***

Department Response:

Kansas statutues provide that either **cash or securities of the kinds in which such a company is permitted to invest its funds.** Companies at organization are allowed to invest in securities in the form as allowed as if the company were already in existence. To allow fairness, all companies no matter the lenghth of existence, are allowed to invest in funds as permitted by statute. Investments that are allowable bey statute are considered marketable.

**KSA 40-230a-Deposit of securities purchased from sale of stock during organization period** states "That the proceeds from the sale of stock during the period of organization fo any insurance company now being or hereafter to be organized under the laws of this state shall be immediately invested in such securites as are permitted by law

**KSA 40-401-Life Insurance**- states "The amount of capital stock of a company organized on the stock plan shall be not less than $600,000. Companies organized on the mutual plan shall be required to have applications from at least 200 persons for insurance upon their lives, aggregating not less than $400,000, upon which one full annual premium in **cash** shall have been paid. No such company shall transact any business of insurance until, if a stock company, all the capital stock named in its charter has been paid in **cash** including all contributions to surplus to be made by the original purchasers of such stock. The surplus shall be at least $600,000, and at least $400,000, in securities authorized by this code shall have been deposited with the state treasurer and commissioner of insurance as joint custodians and if a mutual company a guaranty fund of at least $1,200,000, and at least $400,000 of which shall be in securities as authorized in this code"

**KSA 40-902- Fire Insurance Companies**-states "Every stock fire insurance company organized under the laws of thsi state, shall deliver to the commissioner of insurance **cash or securities of the kinds in which such a company is permitted to invest its funds** under the provisions of this code, in an amount equal to not less than the minimum capital stock required of such a company

**KSA 40-1103-Casualty, Surety and Fidelity Companies**-states "No insurance company hereafter organized under the laws of this state shall beauthorized to commence the transaction of either of the numbered classes of busniness specified in KSA 40-1102, and amendments therto, in this state unless it has a capital stock of at least $450,000 and a surplus of at least $300,000, both fully paid in **cash,** and shall have deposited with the state treasurer and commissioner of insurance as joint custodians securities authorized be KSA 40-2a01, et seq and amendments therto, in an amount equal to not less than the minimum capital stock required of such company.

**KSA 40-1204(c)-Mutual Insurance Companies Other Than Life**-states "It shall have collected the full consideration according to its filed rate on each contract applied for. The total of such considerations shall be held in **cash or securities in which such insurance companies are authorized by law to invest**

The above statutes provide for capital and surplus at organization to be in the form of cash or securities of the kinds which such insurance companies are permitted or authorized by law to invest. The statutes provide investments such as Bonds, Stocks, Equipment Trust Obligations, Certificate's of Deposit, Real Estate, Mortgage Loans, Savings Deposits, Repuchase Agreements, Collateral Loans, and Data Processing Equipment. Undoubtedly some of these investments are more liquid than others, however, all of the above investments are marketable.

### 3. NAIC Accounting Practices and Procedures

The department should require that all companies reporting to the department file the appropriate NAIC annual statement blank which should be prepared in accordance with the NAIC's instructions handbook and follow those accounting procedures and practices prescribed by the NAIC's Accounting Practices and Procedures Manual.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on NAIC accounting practices and procedures? | **XXX** | |
| b) Cite the law or regulation **KSA 40-225** | | |
| c) Does the department's requirement that companies file appropriate NAIC annual statement blanks prepared in accordance with the NAIC's Annual Statement Instructions and following the NAIC's Accounting Practices and Procedures Manual apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas code section cited makes reference to the NAIC convention blank form adopted, however, there is no indication in the code section that the annual statement should be prepared in accordance with the NAIC's Annual Statement Instructions Handbook and that the accounting practices and procedures prescribed by the NAIC's Accounting Practices and Procedures Manual should be followed***

Department Response:

**KSA 40-225-Company participation in surance regulatory information system**-states " Every insurance company or fraternal benefit society doing business in this state shall, if the statement of condition required below is compatible, participate in the insurance regulatory information system administered by the national association of insurance commissioners ...Such statement shall be made upon the form prescribed and adopted from time to time by the national association of insurance commissioners ...true exhibit of their condition."

It must be assumed and is the Department's position that to properly complete the annual statement as prescribed by the national association of insurance commissioners that the NAIC's Annual Statement Instructions Handbook and the accounting practices and procedures prescribed by the MAIC's Accounting Practices and Procedures Manual should be adhered to.

## 4. Corrective Action

State Law should contain the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in a Hazardous financial Condition or a substantially similar provision which authorizes the department to order a company to take necessary corrective action or cease and desist certain practices which, if not corrected, could place the company in a hazardous financial condition.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on corrective action? | **XXX** | |
| b) Cite the law or regulation. **KSA 40-222, 222b, 222c, 222d, 222e** | | |
| c) Does the department's authority to order a company to take necessary corrective action or cease and desist certain practices which, if not corrected, could place the company in a hazardous financial condition apply to all regulaated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas code sections satisfy the requirement concerning standards on corrective action.***

## 5. Valuation of Investments

The department should require that securities owned by insurance companies be valued in accordance with those standards promulgated by the NAIC's Valuation of Securities Office. Other invested assets should be required to be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (EX4) Subcommittee.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on valuation of investments: | **XXX** | |
| b) Cite the law or regulation **KSA 40-225** | | |
| c) Does the department's requirement that securities be valued in accordance with the standards promulgated by the NAIC's Valuation of Securities Office and that other invested assets be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (EX4) Subcommittee apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above respones, please use the space below. | | |

**In addition, the Kansas Supreme Court Case of National Mutual Casualty Company vs Hobbs gives the Commissioner broad authority to value assets and establish liabilities of insurance companies**

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***Comments from Detailed Review***

***The Kansas code section cited refers to the annual statement which is required to be filed by insurers. The code section and case law cited has no reference to any requirement that securities owned by an insurance company be valued in accordance with those standards promulgated by the NAIC's Valuation of Securities Office and that other invested assets be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (EX4) Subcommittee.***

Department Response:

It must be assumed and is the Department's position that to properly complete the annual statement as prescribed by the national association of insurance commissioners that the NAIC's Annual Statement Instructions Handbook and the accounting practices and procedures prescribed by the MAIC's Accounting Practices and Procedures Manual should be adhered to.

The Annual Statement Instructions for both Life and Property & Casualty companies states that "The Valuation of Securities manual should be referred to for procedures to determine securities values".

## 6. Holding Company Systems

State law should contain the NAIC Model Holding Company Systems Act or an Act substantially similar and the department should have adopted the NAIC's model regulation relating to this law.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on holding company systems? | **XXX** | |
| b) Cite the law or regulation<br>**KSA 40-3301, KAR 40-1-28** | | |
| c) Does the department's authority regarding the regulation of holding company systems apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below.<br>**HMO's are excluded from the provisions of the holding company act.** | | |

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***Comments from Detailed Review***

***The Kansas code does not contain Section 3.1 of the Model Act concerning acquisitions involving insurers not otherwise covered.***

Department Response:

True

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***The Kansas law does not require that dividends and other distributions to shareholders and consolidated tax allocation agreements be included in the registration statement or any pledge of the insurer's stock, including stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system.***

Department Response:

Form B "Insurance Holding Company System Annual Registration Statement" Item 5. Transactions and Agreements Sections 7, 8, and 9 respond to dividends and other distributions to shareholders; consolidated tax allocation agreements; and any pledge of the Registrant's stock and/or of the stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system.

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***The Kansas laws does not require the reporting of dividends to shareholders as required under Section 4(e) of the Model Act.***

Department Response:

KSA 40-3305(d) states "Each registered insurer...each registered insurer shall reposrt all dividends and other distributions to shareholders wihtin two business days following the declaration thereof.

## 6. Holding Company Systems (Continued)

***The standards for transactions within a holding company system are outlined in Section 5 of the Model Act. In addition to the terms being fair and reasonable, the Model Act also requires that the charges or fees for services performed be reasonable and that expenses incurred in payment received be allocated to the insurer in conformity with customary insurance accounting practices consistently applied. Kansas law has the requirement that the term be fair and reasonable but not the remaineder of the provisions.***

Department Response:

KSA 40-3306(a) states "Material transactions by registered insurers with their affiliates shall be subject to the following standards:

(1) The terms shall be fair and reasonable;
(2) the books, accounts and records of each party shall be so maintained as to clearly and accurately disclose the precise nature and details of the transactions; and
(3) the insurer's surplus as regards policyholders following any dividends or distributions to shareholder affiliates shall be reasonable in relation to the insurer's outstanding liabilites and adequate to its financial needs."

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***Section 5(a)(2) of the Model Act specifies several types of transactions within a holding company system which require prior written notification to the department at least 30 days prior to the transaction. There ar no similar requirements in the Kansas code. The Kansas law does include the thirty (30) day notice for payment of extraordinary dividends.***

Department Response:

True

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***The Model Act at Section 10 includes extensive sanctions. The Kansas law allows the commssioner to suspend, revoke or refuse to renew and insure certificate of authority and a fine of $20,000 but not the remainder of the sanctions in the Model.***

Department Response:

True

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***The Kansas code sections cited do not include the provisions of the follwoing sections of the Model Act: Section 12 (Recovery), Section 14 (Judicial Review, Mandamus), Section 15 (Conflict with Other Laws).***

Department Response:

True

1991 Senate Bill No. 67 will bring the Kansas Holding Company Act up to date and thereby satisfy this part of the NAIC standards.

## 7. Risk Limitation

State law should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk based upon the company's capital and surplus which should be no larger than 10% of the company's capital and surplus.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on risk limitation? | **XXX** | |
| b) Cite the law or regulation<br>**KSA 40-1107, 1204** | | |
| c) Does the maximum net amount of risk to be retained by a property and liability company apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | | **XXX** |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

**Captives do not have a risk retention requirement; title companies have a 50% retention requirement and domestic mutual medical malpractice companies have a 20% risk retention requirement. Life companies and HMO's do not have risk retention requirements.**

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***Comments from Detailed Review***

***The Kansas laws requires risk limitation, with a few exceptions. Captives do not have the risk retention requirement; title companies have a 50% requirement and domestic mutual medical malpractice have a 20% requirement.***

Department Response:

True

## 8. Investment Regulations

State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on investment regulations? | **XXX** | |
| b) Cite the law or regulation<br>**Articles 2a and 2b of Chapter 40 of the Kansas Statutes, National Mutual Casualty vs Hobbs, KSA 40-222, 222b, 222d** | | |
| c) Does the requirement for companies to maintain a diversified investment portfolio as to type and issue including a requirement for liquidity apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below.<br>**HMO's are excluded.** | | |

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***Comments from Detailed Review***

***The Kansas code sections cited do not address diversification as to type of investment or liquidity requirements.***

Department Response:

True, however Articles 2a and 2b, National Mutual Casualty Co vs Hobbs, and KSA 40-222, 222b, 222d, this Departments statute require a diversified investment portfolio for all insurers and includes a requirement for liquidity and duration matching based on the nature of the insurance underwritten.

## 9. Admitted Assets

State statute should describe those assets which may be admitted, authorized or allowed as assets in the statutory financial statement of insurers.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on admitted assets? | **XXX** | |
| b) Cite the law or regulation<br>**KSA 40-225 and National Mutual Casualty vs Hobbs** | | |
| c) Does the description of assets which may be admitted, authorized, or allowed as assets in the statuttory financial statements of insurers apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas code section cited states which investments may be authorized or allowed as assets in the statutory financial statement of insurer, however, it does not address other types of assets in addition to investments.***

Department Response:

True

However, this standard is met by adherence to the NAIC's Accounting Practices and Procedures Manual which Kansas requires by virtue of K.S.A. 40-225.

## 10. Liabilities and Reserves

State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer; including, life reserves, active life reserves and unearned premium reserves and liabilities for claims and losses unpaid and incurred but not reported claims.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on liabilities and reserves? | **XXX** | |
| b) Cite the law or regulation<br>**KSA 40-225, 234, 409 and 428** | | |
| c) Does the minimum standards for the establisment of liabilities and reserves resulting from insurance contracts issued by an insurer apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas statutes cited satisfy the standard on liabilities and reserves.***

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**11. Reinsurance Ceded**

State law should contain the NAIC Model Law on Credit for Reinsurance and the Model Regulation for Life Reinsurance Agreements or substantially similar laws.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on property and liability reinsurance ceded? | **XXX** | |
| b) Cite the law or regulation **KSA 40-221a** | | |
| c) Does the state have a law or regualtion which satisfies the standard on life and health reinsurance ceded? | **XXX** | |
| d) Cite the law or regulation **KSA 40-221a** | | |
| e) Does the department's authority regarding the regulation of reinsurance ceded apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |

d) If further explanation is required to amplify the above responses, please use the space below.

**There is no specific statutory authority similar to the Model Regulation for Life Reinsurance Agreements. However, Pursuant to the authority granted the Commissioner by National Mutual Casualty Comapny vs. Hobbs, the Department can disallow credit for reinsurance if we do not feel such credit is appropriate, i.e. no transfer of risk, etc.**

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***Comments from Detailed Review***

***The Kansas statute is not based on the NAIC Model Law on Credit for Reinsurance and is not substantially similar to that Model. The Kansas Department states that there is no specific statutory authority similar to the Model Regulation for Life Reinsurance Agreements, howver, it states that, pursuant to the authority granted the commissioner by caselaw, the department can disallow credit for reinsurance if the department does not feel such credit appropriate.***

Department Response:

True

Model Regulation on Life Reinsurance will be proposed for adoption in the near future.
In December, 1990 a model law relating to regulation of reinsurance intermediaries was added to the NAIC standards. It is anticipated that this law will be presented to the 1992 legislature for consideration.

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## 12. CPA Audits

State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants, such as contained in the NAIC's Model Requiring Annual Audited Financial Reports.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on CPA audits? | **XXX** | |
| b) Cite the law or regulation **KSA 40-225, KAR 40-1-37** | | |
| c) Does the requirement for annual audits of domestic insurance companies apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas law and regulation requires CPA audits.***

### 13. Actuarial Opinion

State statute or regulation should contain a requirement for an opinion on life and health policy and claim reserves and loss and loss adjustment expense reserves by a qualified actuary or specialist on an annual basis for all domestic insurance companies

| Question | | YES | NO |
|---|---|---|---|
| a) | Does the state have a law or regulation which satisfies the standard on actuarial opinions? | XXX | |
| b) | Cite the law or regulation<br>**KSA 40-225** | | |
| c) | Does the requirement for annual actuarial opinions on the policy and claim reserves or loss and loss adjustment expense reserves of domestic companies apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | XXX | |
| d) | If further explanation is required to amplify the above responses, please use the space below. | | |

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***Comments from Detailed Review***

***The Kansas statutes does not specifically require an opinion on life and health policy and claim reserves and property and liability loss and loss adjustment expense reserves by qualified actuary or specialists on an annual basis for all domestic insurance companies.***

Department Response:

It must be assumed and is the Department's position that to properly complete the annual statement as prescribed by the national association of insurance commissioners that the NAIC's Annual Statement Instructions Handbook and the accounting practices and procedures prescribed by the NAIC's Accounting Practices and Procedures Manual should be adhered to.

The Annual Statement Instructions for Life (Sect. 14 (1)) states that "There is to be included on or attached to Page 1 of the Annual Statement, the statement of a qualified actuary, entitled "Statement of Actuarial Opinion," setting forth his or her opinion relating to policy reserves and and other actuarial items"

The Annual Statement Instructions for Property and Casualty (Sect. 12 (1)) states that "There is to be included on or attached to Page 1 of the Annual Statement, the statement of a qualified actuary, entitled "Statement of Actuarial Opinion," setting forth his or her opinion relating to loss and loss adjustment expense reserves">

**14. Receivership**

State law should set forth a receivership scheme for the administration, by the insurance commissioner, of insurance companies found to be insolvent as set forth in the NAIC's Model Law on Supervision,Conservation, Rehabilitation and Liquidation.

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on receivership? | **XXX** | |
| b) Cite the law or regulation<br>**KSA 40-3601 et.seq.** | | |
| c) Does the department's authority for the administration of insolvent insurance companies apply to all regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | **XXX** | |
| d) If further explanation is required to amplify the above responses, please use the space below.<br>**HMO's might be excluded** | | |

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***Comments from Detailed Review***

***The Kansas statutes cited pertain to the distribution of assets, order of claims, and agents offset of unearned premiums. The remainder of the NAIC Model is not addressed.***

1991 Legislative Proposal No. 1 (This bill has not yet been printed.) addresses this deficiency.

## 15. Guaranty funds

State law should provide for a statutory mechanism, such as that contained in the NAIC's model acts on the subject, to ensure the payment of policyholders obligations subject to appropriate restrictions and limitations when a company is deemed insolvent.

| Question | | YES | NO |
|---|---|---|---|
| a) | Does the state have a law or regulation which satisfies the standard on guaranty funds? | **XXX** | |
| b) | Cite the law or regulation<br>**KSA 40-2901, 3001** | | |
| c) | Does the statutory mechanism which ensures the payment of policyholders obligations subject to appropriate restrictions and limitations when a company is deemed insolvent prohibit the inclusion of certain regulated entities (reinsurers, captives, and other special charter or special act companies, etc.)? | XXX | ~~XXX~~ |
| d) | If further explanation is required to amplify the above responses, please use the space below. | | |

**HMO's, captives, and Blue Cross and Blue Shield organizations are excluded.**

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***Comments from Detailed Review***

***Kansas has adopted guaranty associations for property/casualty and life/health guaranty funds.***

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NOTE:

Upon further review, we find that no state has enacted this law because of its apparently controversial nature. Since the NAIC standards permit a state to fail to meet one of the standards without jeopardizing accreditation, Kansas is not intending to meet this standard at this time.

## 16. Other

a) State statute should contain a provision similar to that NAIC Model Act requiring domestic insurance companies to participate in the NAIC Insurance Regulatory Information System (IRIS).

| Question | YES | NO |
|---|---|---|
| a) Does the state have a law or regulation which satisfies the standard on NAIC Insurance Regulatory Information System participation? | **XXX** | |
| b) Cite the law or regulation **KSA 40-225** | | |
| c) Does the state have a law or regulation which satisfies the standard on risk retention groups and purchasing groups? | **XXX** | |
| d) Cite the law or regulation **KSA 40-4101** | | |
| e) Does the state have a law or regulation which satisfies the standard on business transacted with a producer controlled property and liability insurer? | | **XXX** |
| f) Cite the law or regulation | | |
| g) If further explanation is required to amplify the above responses, please use the space below. | | |

**The Kansas Insurance Department plans to introduce legislation regulating business transacted with a producer controlled property and liability insurer in either the 1990 or 19910sessions of the Kansas Legislature**

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***Comments from Detailed Review***

***The Kansas statutes satisfy the standard on NAIC Insurance Regulatory Information System (IRIS) participation.***

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b) State law should contain a provision similar to the NAIC's Model Risk Retention Act for the regulation of risk retention groups and purchasing groups.

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***Comments from Detailed Review***

***The Kansas Statutes satisfy the standard on risk retention groups and purchasing groups***

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c) State statute should contain the NAIC's Model Law for Business Transacted with Producer Controlled Property/Casualty Insurer Act or a similar provision.

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***Comments from Detailed Review***

***The Kansas Insurance Department states that it plans to introduce legislation regulating business transacted with a producer or controlled property and liability insurer in either the 1990 or 1991 sessions of the Kansas Legislature.*** (See "Note" on next page)

# NAIC POLICY STATEMENT ON FINANCIAL REGULATION STANDARDS

## Introduction

The safety and soundness of insurance companies operating in the United States is a prime objective of state insurance regulators. In many respects non-domiciliary states rely and depend to a great extent on domiciliary insurance departments to effectively monitor and regulate their domestic companies. To ensure that these concerns and objectives are met, an effective financial surveillance and regulation structure and system is needed. While everyone can agree that this is critical, to date no one has yet defined what constitutes an effective structure and system for financial surveillance and regulation. While the NAIC has done a great deal to foster uniformity and sound regulation through various model laws and regulations and standardized financial reporting formats and instructions as well as the development of a variety of manuals and other tools to assist state insurance departments, a comprehensive pronouncement on all functions and procedures relating to financial regulation has not been done. The objective of the NAIC Committee on Financial Regulation Standards is to establish standards for the NAIC and state insurance departments in this important area.

It is believed that establishing standards for financial regulation will have the following positive results:

(1) Strengthen state insurance departments through self-evaluation and improvement to meet the prescribed standards.

(2) Demonstrate to, and obtain from, state administrations and legislative bodies the support and resources needed to maintain an effective system of financial surveillance and regulation.

(3) Create a national standard for financial regulation which will improve and strengthen the state regulatory system of insurance and the safety and soundness of insurance companies.

(4) A standard established by the NAIC will, if attained, ensure that each jurisdiction is monitoring and regulating domestic companies operating in other jurisdictions on an admitted or non-admitted basis or as a risk retention group.

(5) Improve the efficiency of state regulation by eliminating duplicative procedures and activities and unnecessary state-by state variations.

The standards recognize the realities of the diverse circumstances of state insurance departments. Standards for financial regulation have been divided into three major categories—(1) laws and regulations; (2) regulatory practices and procedures; and (3) organizational and personnel practices.

## A. Laws and Regulations

1. *Examination Authority*

The department should have authority to examine companies whenever it is deemed necessary. Such authority should include complete access to the company's books and records and, if necessary, the records of any affiliated company, agent, and/or managing general agent. Such authority should extend not only to inspect books and records but also to examine officers, employees and agents of the company under oath when deemed necessary with respect to transactions directly or indirectly related to the company under examination.

**Editor's Note:** At the December 1990 NAIC national meeting, the association voted to make the newly adopted Model Law on Examination part of the financial regulation standards.

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2. *Capital and Surplus Requirement*

The department should have the ability to require that insurers have and maintain a minimum level of capital and surplus to transact business. The department should have the authority to require additional capital and surplus based upon the type, volume and nature of insurance business transacted.

3. *NAIC Accounting Practices and Procedures*

The department should require that all companies reporting to the department file the appropriate NAIC annual statement blank which should be prepared in accordance with the NAIC's instructions handbook and follow those accounting procedures and practices prescribed by the NAIC's Accounting Practices and Procedures Manual.

4. *Corrective Action*

State law should contain the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition or a substantially similar provision which authorizes the department to order a company to take necessary corrective action or cease and desist certain practices which, if not corrected, could place the company in a hazardous financial condition.

5. *Valuation of Investments*

The department should require that securities owned by insurance companies be valued in accordance with those standards promulgated by the NAIC's Valuation of Securities Office. Other invested assets should be required to be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (EX4) Subcommittee.

6. *Holding Company Systems*

State law should contain the NAIC Model Insurance Holding Company System Regulatory Act or an Act substantially similar and the department should have adopted the NAIC's model regulation relating to this law.

7. *Risk Limitation*

State law should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk based upon the company's capital and surplus which should be no larger than 10% of the company's capital and surplus.

8. *Investment Regulations*

State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

9. *Admitted Assets*

State statute should describe those assets which may be admitted, authorized or allowed as assets in the statutory financial statement of insurers.

10. *Liabilities and Reserves*

State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer; including life reserves, active life reserves and unearned premium reserves, and liabilities for claims and losses unpaid and incurred but not reported claims.

11. *Reinsurance Ceded*

State law should contain the NAIC Model Law on Credit for Reinsurance and the Model Regulation for Life Reinsurance Agreements or substantially similar laws.

12. *CPA Audits*

State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants, such as contained in the NAIC's Model Rule Requiring Annual Audited Financial Reports.

13. *Actuarial Opinion*

State statute or regulation should contain a requirement for an opinion on life and health policy and claim reserves and loss and loss adjustment expense reserves by a qualified actuary or specialist on an annual basis for all domestic insurance companies.

14. *Receivership*

State law should set forth a receivership scheme for the administration, by the insurance commissioner, of insurance companies found to be insolvent as set forth in the NAIC's Insurers Supervision, Rehabilitation and Liquidation Model Act.

15. *Guaranty Funds*

State law should provide for a statutory mechanism, such as that contained in the NAIC's model acts on the subject, to ensure the payment of policyholders obligations subject to appropriate restrictions and limitations when a company is deemed insolvent.

16. *Other*

(a) State statute should contain a provision similar to the NAIC model act requiring domestic insurance companies to participate in the NAIC Insurance Regulatory Information System (IRIS).

(b) State law should contain a provision similar to the NAIC's Model Risk Retention Act for the regulation of risk retention groups and purchasing groups.

(c) State statute should contain the NAIC's model law for Business Transacted with Producer Controlled Property/Casualty Insurer Act or a similar provision.

**Editor's Note:** At the December 1990 NAIC national meeting, the association voted to add two more models to the standards. These are the Managing General Agents Act and the Reinsurance Intermediaries Model Act. Descriptive paragraphs about these two models will be included in the future.

## B. Regulatory Practices and Procedures

1. *Financial Analysis*

(a) The department should have a sufficient staff of financial analysts with the capacity to effectively review the financial statements as well as other information and data to discern potential and actual financial problems of domestic insurance companies.

(b) The department should have an intra-department communication and reporting system that assures that all relevant information and data received by the department which may assist in the financial analysis process is directed to the financial analysis staff.

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(c) The internal financial analysis process should provide for levels of review and reporting.

(d) The financial analysis procedure should be priority-based to ensure that potential problem companies are reviewed promptly. Such a prioritization scheme should utilize the NAIC's Insurance Regulatory Information System and/or a state's own system.

2. *Financial Examinations*

(a) The department should have the resources to examine all domestic companies on a periodic basis which is commensurate with the financial strengths and position of the insurer.

(b) The department's examination staff should consist of a variety of specialists with training and/or experience in the following areas or otherwise have available qualified specialists which will permit the department to effectively examine any insurer: computer audit specialist, reinsurance specialist, life and health company examiners, property and liability company examiners, life and health actuarial examiners, property and liability actuarial examiners and property and liability claims examiners.

(c) The department's procedures for examinations shall provide for supervisory review within the department of examination work papers and reports to ensure that the examination procedures and findings are appropriate and complete and that the examination was conducted in an efficient and timely manner.

(d) The department's policy and procedures for examinations should follow those that are set forth in the NAIC's Examiners Handbook.

(e) In scheduling financial examinations the department should follow those procedures set forth in the NAIC's Examiners Handbook and this schedule system should provide for the periodic examination of all domestic companies on a timely basis. This system should accord priority to companies which are having adverse financial trends or otherwise demonstrate a need for examination such as determinations of the NAIC IRIS Examiner Team.

(f) The department's procedures require that all examination reports which contain material adverse findings be promptly presented to the commissioner or his designee for a determination and implementation of appropriate regulatory action.

(g) The department's reports of examination should be prepared in accordance with the format adopted by the NAIC and should be sent to other states in which the company transacts business in a timely fashion.

3. *Other*

When a domestic company is identified as troubled this should be communicated to other insurance departments in jurisdictions in which the carrier transacts business. When a foreign company is identified as troubled this should be communicated to the domiciliary insurance department of the carrier.

**Note:** A troubled company is defined as an insurance company that has not maintained a financial position, or whose operations are moving toward a financial result that would indicate that its policyholders and claimants are subject to potential risk or that the specified statutory minimum capital and surplus requirements may not be maintained.

**Drafting Note:** When the NAIC's Troubled Insurance Company Manual is completed and adopted, a statement should be incorporated into this Policy Statement requiring states to generally follow and observe the procedures set forth in the manual.

## C. Organizational and Personnel Practices

1. The department should have a policy which requires the professional development of staff through job-related college courses, professional programs and/or other training programs which are funded by the department.

2. All financial regulation and surveillance activities are the responsibility of an individual who shall report to the commissioner or his designee.

3. The department's staff and contractual staff involved in financial regulation and surveillance should all be periodically evaluated by the department to ensure that job duties and responsibilities are being discharged in a satisfactory manner.

4. The department should establish minimum educational and experience requirements for all professional employees and contractual staff positions in the financial surveillance and regulation area which are commensurate with the duties and responsibilities of the position.

5. The department's pay structure for those positions involved with financial surveillance and regulation should be competitively based to attract and retain qualified personnel.

6. The department's funding should be sufficient to allow for the financial surveillance and regulation staff's participation as appropriate in the meetings and training sessions of the NAIC and meetings relating to the review, coordination and the development and implementation of action for troubled insurers.

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*Legislative History (all references are to the* Proceedings of the NAIC)

*1989 Proc. II 13, 21, 33-36 (adopted).*
*1991 Proc. I (voted to add three new models to standards).*

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NATIONAL CONFERENCE OF STATE LEGISLATURES

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**Statement on Insurance Company Insolvencies**

The safety and soundness of insurance companies operating in the United States is a prime objective of state insurance regulation. To ensure that this objective is met, an effective financial surveillance and regulation system is needed. This will require immediate state action to strengthen state insurance departments and to create standards for financial regulation that will strengthen the safety and soundness of insurance companies.

First of all, state insurance regulation must be strengthened in order to protect policyholders. The public depends on solvent insurance companies to provide retirement income, income protection in case of death or disability, protection from catastrophic loss, and safe investment opportunities.

Secondly, solvency regulation must be improved in order to protect state treasuries. When an insurance company fails, healthy companies are assessed to pay off policyholders. Many states allow such assessments, under state guaranty fund systems, to be offset against state premium taxes. In addition, some state pension funds and a few bond issuers have purchased guaranteed investment contracts that depend on the solvency of life insurance companies. Finally, if state guaranty fund systems were to collapse under the weight of too many insolvencies, some moral obligation on the state to protect policyholders might be alleged.

A third important reason for state action, as soon as possible, is to provide an alternative to federal intervention. Some consumer advocates and insurance executives already are calling for federal legislation that would preempt state authority. Additionally, there is a concern that such federal action could lead to federal preemption of the states' insurance premium tax base. We believe there are many advantages to state regulatory authority, including staff expertise that has developed over many years. The National Conference of State Legislatures (NCSL) believes that a heavy burden of proof must be met before federal intervention and preemption are justified. The NCSL recognizes that swift and effective action by state legislatures to reform state solvency regulation will serve to deter any unjustified federal preemption.

Improving state regulation of insurance for solvency will require attention (1) to laws and regulations, (2) to regulatory practices and procedures, and (3) to the possible need for additional resources, expertise and state legislative oversight to ensure their effective implementation. In order to achieve these goals, NCSL recommends adoption of the model laws and regulations developed by the National Association of Insurance Commissioners (NAIC), as summarized below in A and B.

Post-it™ brand fax transmittal memo 7671 # of pages ▸ 4
To Dick Brock From Sandra Gilfillan
Co. Co. NAIC
Dept. Phone #
Fax # Fax #

## A. LAWS AND REGULATIONS

1. Examination Authority: Each insurance department should have adequate authority to examine the finances of insurance companies whenever it is deemed necessary.

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2. Capital and Surplus Requirements: State law should require that insurers have and maintain a minimum level of capital and surplus to transact business. State law should require additional capital and surplus based upon the type, volume and nature of insurance business transacted.

3. Accounting Practices and Procedures: Each insurance department should require that all companies adopt appropriate accounting practices and procedures.

4. Corrective Action: State law should provide sufficient authority for the state insurance department to order a company to take necessary corrective action when it is deemed to be in hazardous financial condition or to cease and desist in certain practices which, if not corrected, could place the company in a hazardous financial condition.

5. Valuation of Investments: Each department should require that securities and other invested assets owned by insurance companies be valued in accordance with recognized standards.

6. Holding Company Systems: State statute should provide for the proper regulation of insurance holding companies.

7. Risk Limitation: State statute and regulation should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk, based upon the company's capital and surplus.

8. Investment Regulations: State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

9. Admitted Assets: State statute should describe those assets which may be admitted, authorized or allowed as assets in the statutory financial statement of insurers.

10. Liabilities and Reserves: State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer.

11. Reinsurance Ceded: State statute should provide for regulation of credit for reinsurance and reinsurance agreements.

12. CPA Audits: State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants.

13. Actuarial Opinion: State statute or regulation should contain a requirement for an opinion on life and health policy claim reserves and loss, and loss adjustment expense reserves of property and casualty companies by a qualified actuary or specialist on an annual basis for all domestic insurance companies.

14. Receivership: State statute should set forth a receivership mechanism for the administration, by the insurance commissioner, of insurance companies found to be insolvent.

15. Guaranty Funds: State statute should ensure the payment of policyholder obligations subject to appropriate restrictions and limitations when a company is deemed insolvent.

16. Regulation of Managing General Agents: State statute should provide for regulation of managing general agents.

17. Regulation of Reinsurance Intermediaries: State statute should provide for regulation of reinsurance intermediaries.

18. Regulation Information: State statute should require domestic insurance companies to participate in the NAIC Insurance Regulatory Information System (IRIS).

19. Risk Retention Groups: State statute should provide appropriately for the regulation of risk retention groups and purchasing groups.

20. Producer Controlled Insurers: State statute should provide for regulation of business transacted with a producer controlled property/casualty insurer.

## B. REGULATORY PRACTICES AND PROCEDURES

1. Financial Analysis: Each state insurance department should have a sufficient staff of financial analysts with the capacity to effectively review the financial statements as well as other information and data to discern potential and actual financial problems of domestic insurance companies.

2. Examinations: Each state insurance department should have the resources to regularly examine all domestic companies.

3. Professionalism: Each department's examination staff should consist of a variety of specialists with the training and/or experience that will allow for the effective examination of any insurer.

4. Priority Examinations: In scheduling financial examinations, each department should accord priority to companies that are experiencing adverse financial circumstances.

5. Interstate Communication: When a domestic company is identified as troubled, this should be communicated to other insurance departments in jurisdictions in which the carrier transacts business. When a foreign company is identified as troubled, this should be communicated to the domiciliary insurance department of the carrier.

The standards set forth in sections A and B are submitted as minimum requirements for the effective regulation by a state of the financial solvency of those insurance companies doing business within that state. Each state should consider whether the enactment of additional safeguards beyond these minimum requirements would be appropriate for that jurisdiction.

For most states, the enactment and implementation of the standards set forth herein will entail additional expense. To determine the precise needs in furthering the goals stated

herein, state legislatures and regulators could embark on a thorough review of existing resources, management operations, and policy implementation procedures. State legislatures could exercise appropriate oversight of their insurance departments through their standing committees and budget process, and through performance, management and compliance audits. In order to obtain necessary funding without further burden to taxpayers, states could consider the imposition of a special assessment on insurance companies doing business within the state in order to defray the increased cost of regulation.

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Testimony By

Dick Brock, Kansas Insurance Department

Before the House Insurance Committee

Senate Bill No. 67

March 25, 1991

In the late 1960s and early '70s, the American business community discovered the advantages of diversification. Some observers at the time were suspicious of the motives of those seeking to acquire ownership and control of insurance companies believing that the primary purpose of such activity was to circumvent many of the statutes that regulate the formation, management, investments and other operations of insurance companies. Others were less suspicious in that the acquisition of insurance companies by non-insurance interests would produce more access to capital markets, enhance profitability through new lines of business, and better serve expanding public needs through a more comprehensive range of financial services.

Regardless of which view was correct, it became evident that the interests of policyholders could be adversely affected if control of an insurer was sought for nefarious reasons, such acquisition would substantially lessen competition and/or, more important, the assets of the insurer were depleted or its financial condition otherwise jeopardized by transactions or relationships over which there was inadequate or no regulatory oversight or control.

Therefore, to meet the regulatory needs revealed by the acquisition and merger of insurance companies, the National Association of Insurance Commissioners developed and adopted the Insurance Holding Company System Regulatory Act.

With the exception of a section relating to permissible investments, Kansas substantively enacted this act in 1974. The original and

House Insurance
March 25, 1991
Attachment 2

continuing purpose of the Holding Company Act is to protect the interests of the policyholders insured by a domestic insurance company, the controlling interest in which is acquired by a new person or entity. Aside from some fairly technical amendments such as removing the act's application to securityholders, removal of some notification requirements and assigning responsibility for the payment of some of the costs incurred when formal hearings are conducted, the Kansas law relating to holding company systems has not been materially changed since its inception.

Senate Bill No. 67 is intended to update Kansas law by incorporating subsequent NAIC amendments in order that we will be able to exercise some regulatory control over acquisitions, mergers and other holding company transactions not addressed in current statutes. In addition, the bill and the present NAIC model include provisions allowing access to assets of a parent or controlling interest in a holding company system in the event of insolvency of an insurance affiliate; provides for penalties and sanctions that are more compatible with regulatory needs; and, several amendments requiring more information to be provided the Commissioner.

Generally, the proposed changes will:

(1) Authorize the Commissioner to exercise oversight with respect to acquisitions involving non-domiciliary companies doing business in Kansas by giving him or her the authority to take corrective action when an acquisition or merger adversely impacts competition in Kansas.

Kansas policyholders can be greatly effected by acquisitions of a non-domestic insurer or by acquisition of the business of any insurer if the result has a significant impact on the Kansas insurance marketplace. Therefore, New Section 1 authorizes the Commissioner to

issue an order requiring an involved insurer to cease and desist from doing business in this state with respect to the line or lines of business or denying an application to do such business in Kansas where an acquisition is determined to have an anticompetitive impact unless the insurer submits a plan or proposal that will eliminate the problem.

(2) The provisions of New Section 3 extend important authority to the receiver of an insolvent insurer to recover a distribution of assets that may have been made solely for the purpose of moving them beyond the reach of the receiver or otherwise take advantage of the financial condition of the distressed insurer.

(3) The amendments appearing in section 4 pertain to the information required to be provided on registration statements required to be filed with the Commissioner. Specifically, requirements for more information relating to dividends to shareholders, tax allocation agreements and a pledge of the registering insurer's stock will be required on registration statements. Subsection (j) is deleted because the subject matter is now covered by the new penalty provisions proposed in section 6 of the bill.

(4) Section 5 suggests the addition of some provisions to current law which will elicit information or assure the availability of additional information to more clearly determine what constitutes an "extraordinary" dividend and its reasonableness in relation to the insurer's financial condition.

This section also includes new language which provides for prenotification and disapproval authority regarding various specific

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transactions involving a domestic company and any person in its holding company system.

(5) Section 6 replaces the current penalty provisions for violations of the holding company act with more specific penalties. Rather than attempt to accommodate all violations of the holding company act regardless of their nature under a single blanket provision, the new penalty provisions provide for the imposition of a penalty more appropriate to a particular violation.

As I mentioned earlier when I testified on Senate Bill No. 53 dealing with insurance company examinations, Senate Bill No. 67 is the second of the three legislative measures the Department proposed this session to meet the financial regulation standards adopted by the National Association of Insurance Commissioners. Therefore, not only will the amendments proposed by Senate Bill No. 67 fulfill a definite regulatory need and serve the public interest but its enactment will also move us another step forward in our quest for national accreditation.

Testimony By
Dick Brock, Kansas Insurance Department
Before the House Insurance Committee
on Senate Bill No. 111
March 25, 1991

Senate Bill No. 111 represents the joint and cooperative efforts of numerous regulators throughout the United States to bring certainty and uniformity to proceedings involving troubled insurance companies. The bill is long and complex because it is, in essence, a blueprint of the formal legal procedures to be followed in dealing with a company that is in financial difficulty. Needless to say, insurance company insolvencies and financial difficulties present numerous, complex and varying situations but the bill has, in states that have it, proven to be a valuable guide to addressing almost every foreseeable problem that might arise in this area.

Current Kansas law contains provisions for administrative actions the Commissioner make take; a statute dealing with the ability of agents to offset monies they contribute to the process of replacing coverage against premiums they owe an insolvent company; and, a statute prioritizing claims but, otherwise the process is under the exclusive control of whichever court is handling the matter.

The model act, upon which Senate Bill No. 111 is patterned, is divided into four sections and these same divisions can be used for division of Senate Bill No. 111. General Provisions covers Sections 1 through 8 of the bill. These are the provisions having general applicability, such as definitions included in Section 3. Summary Actions is contained in Sections 9, 10, and 11 of the bill. Section 9 provides for summary action by the Commissioner without court intervention, while Sections 10 and 11 deal with action through the courts by the regulator to initiate short term corrective measures. Formal Proceedings is included in

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Sections 12 through 43. Formal proceedings include rehabilitation and liquidation actions by the domiciliary regulator. Interstate Relations is included in Sections 44 through 54. These sections provide the rules for coordination and uniform action among states.

In a state like Kansas which has experienced the insolvency of only one domestic insurer in at least 35 years and no current member of the staff has discovered how long before that, this section is a particular advantage because it permits residents of reciprocal states to elect to file and prove their claims, either in the domiciliary state or in the reciprocal state. A state that has not enacted in substance and effect Sections 18A, 46, 47 and 49 through 51 of this bill cannot be a reciprocal state as defined in the definition section of the bill and claimants are limited in a non-reciprocal state to filing and proving their claims in the domiciliary state.

Beyond that, I will just take you briefly through the process established by Senate Bill No. 111. The first step for the regulator may be -- but does not necessarily have to be -- his or her own administrative order requiring a company to correct their problems and to protect the company's assets. (Section 9, or existing K.S.A. 40-222.) The next step might be -- and I'm saying "might" because the action taken depends on the extent of the financial difficulties -- for the regulator to have the courts order the troubled insurer to take corrective action. (Section 10 and 11.) These actions are summary in nature. If summary action fails, or if the Commissioner elects not to use summary action, the regulator may proceed to formal rehabilitation or insolvency proceedings. These are called formal proceedings and are discussed in the sections from Sections 13 through 44.

As the term implies, rehabilitation proceedings are formal proceedings designed to keep a company operating and are discussed in Sections 13 through 17. Liquidation proceedings are intended to terminate a company and are covered generally in Sections 18 through 44, although a few of these sections also affect rehabilitation proceedings. Needless to say, the termination of a troubled company can involve a number of details such as claims handling procedures (Sections 32 through 36), priority of claims (Section 37), fraudulent transfers (Section 25), voidable preferences (Section 27), and set-offs (Section 29) to name just a few. Finally, since insolvencies generally involve coordination between a number of separate states, the last sections of the act (Sections 44 through 53) deal with interstate relations. As part of interstate relations, provision is made for ancillary receivers in states other than the insurers state of domicile.

As I mentioned earlier, Kansas statutes already contain specific provisions relating to the offset of unearned premiums by agents. These are unique provisions that are not included in the NAIC model law upon which Senate Bill No. 111 is based. Yet, these provisions are beneficial to Kansas agents and, more particularly, their customers when it is necessary to insure a home, car, business or some other risk in a new company because of the insolvency of the previous company. Even with enactment of Senate Bill No. 111, we did not wish to disturb this offset provision but, in the original bill, we inadvertently did so. This error was corrected by the Senate amendments appearing on lines 22, 23 and 24, on page 27. The Senate amendments on lines 14 and 33, page 42, correct an erroneous statutory reference.

Finally, in drafting Senate Bill No. 111, we utilized the most recent edition of the NAIC model. This included Section 29 which begins on page 27 and deals with what in liquidation language are called setoffs. The

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setoff provisions now included in Senate Bill No. 111 were adopted in June 1990 by the NAIC but are quite controversial even in regulatory circles.

Setoff is the term applied to the process whereby a creditor who owes or, pursuant to contract, may become liable for a debt to an insolvent company may offset these obligations against debts the insolvent company owes to the creditor. For example, if a reinsurer owes the insolvent company $3 and the insolvent company owes the reinsurer $2 the result is a payment of $1 to the liquidator of the insolvent company.

Subsection (b)(6) of Section 29 in its current form would prohibit setoffs in cases where a reinsurer and the insolvent company have both ceded and assumed risks from each other. In other words, the solvent reinsurer would continue to owe the estate of the insolvent insurer for debts incurred but could not reduce the actual payment by amounts the insolvent insurer owed the reinsurer.

The purpose of this provision is, of course, to make more assets available to the liquidator. Theoretically, this enhancement would make more assets available for distribution to policyholders but, as a practical matter, the costs and expenses of a liquidation often if not usually and perhaps nearly always, exhaust the assets so no such distribution is available. Or, if it is, the state guaranty funds are in the same class of creditors as policyholders and claimants. Therefore, since most claims have already been paid by the guaranty funds, the beneficiaries of any such distribution would be the insurance companies who belong to the guaranty association.

On the other hand, the absence of setoff has the obvious result of increasing the cost of reinsurance which in turn will be reflected in the

premiums paid by policyholders. Upon reflection, we don't believe this obvious adverse impact on all premiums and all policyholders is justified by the questionable and very uncertain benefit that might flow to policyholders and claimants of the insolvent company.

Therefore, attached to my testimony is a balloon amendment which amends Section 29(b)(6) to permit setoffs except where the same business is being ceded and assumed. In this case, a ceding company can recognize an immediate increase in the ability to write new business even though it has not discharged its original obligations. This is nothing more than a convenient bookkeeping maneuver to artificially enhance surplus and does not merit setoff.

The second amendment on the balloon involves subsection (c) of Section 29. The existing provisions in this subsection require the liquidator to prepare accounting statements listing current debts due and payable by the insolvent insurer for business assumed by a reinsurer. The accounting statements so prepared then become the sole determinant of what setoffs are permitted. While this process could be used by a liquidator to maximize assets of the insolvent insurer, it is an arbitrary approach that will produce inconsistent and unpredictable results. In addition, the time consuming nature of a liquidation proceeding does not require this kind of precipitous action. Therefore, the balloon amendment contains a re-drafted subsection (c) which still requires the receiver to identify the debts due and payable but recognizes that as the reinsurance arrangements progress, reinsurance recoveries or other credits may surface. The amendment requires the reinsurer to pay the known debts but also requires the receiver to refund that amount of such payment as future credits become due. This procedure should produce more consistent and more equitable treatment.

The final amendment involves the effective date of the setoff provisions. The amendment makes it clear that Section 29 does not have a retroactive effect on existing contracts and also recognizes that, unlike a number of states, Section 29 is not an amendment to existing law. Therefore, a transition from the previous setoff provisions to the new ones is not necessary or appropriate.

The language deleted by the balloon amendment involves provisions that are no longer necessary or no longer serve a purpose as a result of the amendments.

New Sec. 28. (a) No claims of a creditor who has received or acquired a preference, lien, conveyance, transfer, assignment or encumbrance voidable under this act, shall be allowed unless the creditor surrenders the preference, lien, conveyance, transfer, assignment or encumbrance. If the avoidance is effected by a proceeding in which a final judgment has been entered, the claim shall not be allowed unless the money is paid or the property is delivered to the liquidator within 30 days from the date of the entering of final judgment, except that the court having jurisdiction over the liquidation may allow further time if there is an appeal or other continuation of the proceeding.

(b) A claim allowable under subsection (a) by reason of the avoidance, whether voluntary or involuntary, or a preference, lien, conveyance, transfer, assignment or encumbrance, may be filed as an excused last filing under section 36 if filed within 30 days from the date of the avoidance, or within the further time allowed by the court under subsection (a).

New Sec. 29. (a) Mutual debts or mutual credits whether arising out of one or more contracts between the insurer and another person in connection with any action or proceeding under this act, shall be setoff and the balance only shall be allowed or paid, except as provided in subsections (b), (c) and (d) of *this* section 32.

(b) No setoff[*, except as provided in K.S.A. 40-3602, and amendments thereto,*] shall be allowed in favor of any person where:

(1) The obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;

(2) the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;

(3) the obligation of the insurer is owed to an affiliate of such person, or any other entity or association other than the person;

(4) the obligation of the person is owed to an affiliate of the insurer, or any other entity or association other than the insurer;

(5) the obligations of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(6) ~~the obligations between the person and the insurer arise from business which is both ceded to and assumed from the insurer except that the rehabilitator may, with regard to such business, allowed certain setoffs in rehabilitation if the rehabilitator shall find the allowance of such setoffs appropriate.~~

~~(c) The liquidator shall provide persons that assumed business~~

the obligations between the person and the insurer arise out of transactions where either the person or the insurer has assumed risks and obligations from the other party and then has ceded back to that party substantially the same risks and obligations.

Delete

~~from the insurer with accounting statements identifying debts which are currently due and payable. Such persons may setoff against such debts only mutual credits which are currently due and payable by the insurer to such persons for the period covered by the accounting statement.~~ — Delete

(c) The receiver shall provide persons with accounting statements identifying debts which are currently due and payable. Accounts currently due and payable as identified by such accounting statements shall be promptly paid to the receiver. However, persons making such payments may setoff against such payments mutual credits currently due and payable by the insurer and may assert setoff of mutual credits which become due and payable from the insurer in the future. Notwithstanding section 37 of this act, the receiver shall promptly and fully refund to the extent of the person's prior payments, any mutual credits so asserted that may become due and payable to the person by the insurer.

~~(d) A person that ceded business to the insurer may setoff debts due the insurer against only those mutual credits which the person has paid or which have been allowed in the insurer's delinquency proceeding.~~

~~(e) Notwithstanding the foregoing, a setoff of sums due on obligations in the nature of those specified in subsection (b)(6) shall be allowed for those sums accruing from business written where: The contracts were entered into, renewed or extended with the express written approval of the commissioner of insurance of domicile of the now-insolvent insurer, when in the judgment of such commissioner it was necessary to provide reinsurance in order to prevent or mitigate a threatened impairment or insolvency of a domiciliary insurer in connection with the exercise of the commissioner's regulatory responsibilities.~~ — Delete

(d) This section shall apply to all contracts entered into, renewed, extended or amended on or after the effective date of this act.

~~(f) These amendments shall become effective six months after the effective date of this act and shall apply to all contracts entered into, renewed, extended or amended on or after that date, and to debts or credits arising from any business written or transactions occurring after the effective date of this act pursuant to any contract including those in existence prior to the effective date of this act, and shall supercede any agreements or contractual provisions which might be construed to enlarge the setoff rights of any person under any contract with the insurer. For purposes of this section any change in the terms of, or consideration for, any such contract shall be deemed an amendment.~~ — Delete

New Sec. 30. Except as provided in K.S.A. 40-3602 and amendments thereto, the amount recoverable by the liquidator from reinsurers shall not be reduced as a result of the delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement. Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the reinsurance contract provided for direct coverage of a named insured and the payment was made in discharge of such obligation.

New Sec. 31. (a) Within 120 days of a final determination of insolvency of an insurer by a court of competent jurisdiction of this state, the liquidator shall make application to the court for approval of a proposal to disburse assets out of marshaled assets, from time