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INSURANCE AND FINANCIAL SERVICES REPORT

STATE-BASED INSURANCE REGULATION IS RESPONSIVE AND EFFECTIVE

By: Diane Koken

**Pennsylvania Insurance Commissioner and
President of the National Association of
Insurance Commissioners**

Introduction

State insurance regulators are public servants who recognize the importance of regulation that balances the need for vigorous consumer protection with vigorous business competition to provide a healthy insurance marketplace for consumers.

In this article, I would like to make three basic points —

- First, the National Association of Insurance Commissioners (“NAIC”) is an organization of state government officials who are sworn to faithfully administer the laws enacted by our respective state legislatures and governors on behalf of our citizens. NAIC members recognize that protecting American consumers is our top priority and the reason for regulating insurers and producers. We are proud that responsive and effective consumer protection is the hallmark of state insurance regulation.
- Second, the states and the NAIC are on time and on target to modernize state regulation where improvements are needed, while preserving the benefits of consumer protection that is our real strength. In some areas, the goal is to achieve national uniformity because it makes sense for both consumers and insurers. In areas where different standards among states reflect regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets. In short, the state regulatory system has already recognized and is working to address legitimate

modernization concerns. The states, more importantly, are committed to a continuing process of modernizing our nation’s regulatory system as the marketplace continues to evolve, and to do so without sacrificing important consumer protections.

- Third, Congress is now considering draft legislation called the State Modernization and Regulatory Transparency Act (the “SMART Act”). The SMART Act incorporates unacceptable levels of federal preemption that would create both legal and practical problems for the insurance industry and its customers. A thorough analysis of the SMART Act by 117 insurance regulatory experts identifies concerns where the draft bill would preempt many important state laws that protect consumers from unfair or discriminatory marketing, inadequate or excessive rates, and unsound products. Federal preemption of state insurance regulation denies consumers the benefits of important state services and protections, as has already been proven in existing federal programs, such as FEMA in its administration of the National Flood Insurance Program, and ERISA through its taking away state authority to assist consumers. The states believe it is constructive to point out basic constitutional, legal, and operational problems that would undermine the SMART Act’s stated purposes.

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Protecting Consumers is the First Priority of State Insurance Regulation

Paying for insurance products is one of the largest annual consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of \$4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure — often required by law or business practice — is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure the promises made by insurance companies are kept.

Because they are typically complex and involve subjective decisions by insurers about policy coverage, rates, and paying claims, insurance products can generate a high level of customer dissatisfaction that requires a high level of regulatory responsiveness. When problems arise, state insurance departments are fully-staffed to handle consumer inquiries and complaints quickly with a local phone call. State regulatory staff are local residents who understand the contract and tort laws that govern insurance products in their state. As regulators of insurance, we are responsible for making sure the expectations of American consumers — including those who are elderly or low-income — are met regarding financial safety and fair treatment by insurance providers. The entire state-based system of insurance regulation and solvency guaranty funds is authorized, funded, and operated by the states, with no cost to the federal government.

As government officials responsible for operating the state system, we understand that any government regulation of business — including insurance — can be inconvenient and occasionally frustrating to commercial entities that wish to do business on their own terms. State regulators are constantly improving our standards and procedures to meet those concerns. Although some industry representatives complain about the state regulatory system being inefficient and burdensome, there is nothing in our experience to indicate that a single federal regulatory solution setting national standards could anticipate and handle insurance supervision as well as the state system had done.

The states believe that consumers are best served by knowledgeable Insurance department employees who are accessible in the state to the consumer, and who understand the local issues impacting the insurance marketplace in their state. During 2003, state insurance departments handled approximately 3.4 million consumer inquiries and complaints regarding the

content of their policies and their treatment by insurance companies and agents. This service to consumers is provided at little or no cost to them, and has resulted in the recovery of substantial consumer restitution.

NAIC and the states reject the notion that consumer protection is incompatible with a vibrant and competitive insurance industry. In fact, we know the opposite to be true. Effective consumer protection is integrally related to maintaining positive business climates in our states. The American insurance industry is the most successful in the world, with countries around the globe seeking to emulate our balanced regulatory environment in order to achieve the kind of consumer and investor confidence necessary to expand their insurance markets.

A few short years ago, there was much talk in the property and casualty industry about rate regulation being a major contributing cause to the industry's anemic financial results. Today, however, the property and casualty industry is sitting on record surpluses, with loss ratios and other key financial indicators being the best in thirty years. Had it not been for the four hurricanes in Florida last year, the industry would have had its best year since the 1950's. While state regulation can be improved, we should be cautious about making radical changes to a regulatory system that delivers for both consumers and insurers.

States Are Well on the Way to Achieving Modernization Goals in the SMART Act

Through testimony, meetings, and correspondence with the U.S. House Financial Services Committee, NAIC members have consistently supported many of the regulatory modernization goals embodied in the draft SMART Act. We have a state-based action plan to achieve those goals that is on-time and on-target to achieve legitimate changes sought by the insurance industry. We want to accomplish needed modernization using the existing state regulatory system that has served our nation well for more than 100 years.

The NAIC's strong commitment to regulatory modernization is set forth in its modernization roadmap document, "Framework for a National System of State-Based Regulation". Here is an update on where we stand:

Life Insurance

- Where appropriate, NAIC and the states are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. Marketing life insurance is an area where we agree with industry that greater uniformity is needed. To accomplish this, the NAIC negotiated development of an appropriate interstate

compact, with full input from industry and consumer representatives. An interstate compact is the best way to get the job done while preserving effective state consumer protections.

- The NAIC finalized model legislation for the Interstate Insurance Product Regulation Compact in July 2003. The Compact creates an interstate commission that will develop national product standards for life insurance, annuities, disability income insurance and long-term care insurance products, as well as create a central point for insurers to file their products. The Compact becomes operational once 26 states or states representing 40% of the premium volume join the Compact. We anticipate that the Compact will become operational in 2006, a remarkable achievement, considering the general rule of thumb for compacts is that it takes anywhere from seven to ten years to get them from the planning stage to becoming operational.
- The NAIC's Interstate Compact National Standards Working Group has developed 33 sets of standards for products that are covered by the Compact. There are 16 life insurance standards, 15 annuity standards, and standards for individual long term care insurance and individual disability income insurance. These standards were thoughtfully drafted and thoroughly vetted by regulators with input from state legislators, the insurance industry, and consumers.

Speed to Market

- Much progress has been made since 1999 to improve the situation for insurers regarding speed to market. While the effort is a work-in-progress that will continuously be enhanced and improved, there have already been many successes. In 1999, the NAIC's System for Electronic Rate and Form Filings, commonly known as SERFF, was in its infancy. There were 1,009 product filings processed through SERFF. Last year, SERFF had grown to 151,064 filings with an average filing turnaround of 23 days. The SERFF system offers a true speed-to-market opportunity to the 1,575 insurers that choose to use this optional regulatory efficiency tool.
- Not all insurers choose to use SERFF, despite the speed to market that it offers. One of the great state regulatory successes is development and implementation of filing review standards checklists. These checklists have been implemented in 46 states, the District of Columbia,

and Puerto Rico. The checklists contain concise lists of the steps an insurer needs to take to submit a compliant product filing. Those insurers choosing to use the checklists have given regulators positive feedback, and report improvements in the timeliness of the product approval process.

Company Licensing

- Efforts to improve standardization and consistency in the licensing of insurers has made significant progress. A best-practices handbook was adopted by the NAIC this year. Among other things, it provides for states to rely on the domiciliary state regulator when assessing the financial condition and executive management of an insurer, and to apply a risk-based methodology for assessing the qualifications of an applicant insurer. A model law on company licensing was initiated at the NAIC 2005 Summer National Meeting in Boston.
- Regulation and financial reporting of reinsurance transactions has taken center stage at the NAIC during recent months. The NAIC moved quickly to design enhanced disclosures for evaluating the use of finite reinsurance by property/casualty insurers. Additionally, the NAIC has been working effectively with U.S. Treasury staff and European regulators regarding the requirement that non-U.S. reinsurers post collateral supporting their liabilities to U.S.-based insurers. State insurance regulators have also been cooperating with the European Commission and its member countries to assist with implementing the EU Insurance Group Directive.
- Financial solvency monitoring and insolvency regulation continues to consume a significant portion of the NAIC agenda. Insurance financial reporting is being further refined to allow earlier detection of troubled insurers. State regulators are adopting a more risk-focused assessment framework toward assessing the solvency position of insurers. Capital adequacy standards are evolving to "principle-based" versus the present formulaic approach. Insurance regulators are pro-actively considering how best to improve the industry's corporate governance practices.
- The NAIC has also been working effectively with members of the International Accounting Standards Board. The NAIC Financial Condition Committee has begun deliberations on a

comprehensive model act designed to modernize and strengthen the authority of Insurance regulators regarding insurer conservation, receiverships, and liquidations. The new model, which is expected to replace the Uniform Receivership Law, will be presented to the full NAIC membership following approval by the Committee.

Market Conduct

- The NAIC is implementing a more effective and efficient market regulatory system based upon the following five primary elements: (1) centralized data collection, (2) structured and uniform market analysis, (3) uniform examination procedures, (4) interstate collaboration, and (5) broader regulatory responses to address general business practices, with specific provisions for targeted examinations.
- To facilitate state collaboration, the NAIC created a Market Analyst's Scorecard to track state actions for the following areas: (1) appointment of a market analysis coordinator, (2) completion of core complaint analysis, (3) coordination with the NAIC's Market Analysis Working Group regarding nationally significant companies, and (4) participation in the NAIC's Market Information Systems. Forty-eight states and the District of Columbia successfully completed the goals outlined in the Market Analyst's Scorecard.
- In 2004, the NAIC published the Market Analysis Handbook to coordinate state market analysis nationally.
- In 2002, the NAIC adopted a comprehensive set of Uniform Examination Procedures, to which 42 states have certified compliance. Uniform procedures make exams more efficient and enhance state collaboration.
- In 2006, the NAIC expects to develop more uniform and better standards for: (1) market analysis, (2) regulatory responses, (3) state authority to analyze, investigate and examine companies and (4) interstate collaboration. The NAIC Market Conduct Annual Statement Project, which will further unify and coordinate state market conduct data requests, became permanent in 2005 with involvement by 17 states. Additional states are expected to participate in 2006.
- Last year, the NAIC adopted a Market Surveillance Model Act providing that targeted or "for cause" examinations be conducted by states

using uniform procedures based upon patterns or practices that deviate significantly from industry norms.

Producer Licensing

- As of today, 42 states have satisfied the producer licensing reciprocity mandates in the NARAB section of the Gramm-Leach-Bliley Act.
- The NAIC has moved well beyond the reciprocal licensing required by the Gramm-Leach-Bliley Act towards the NAIC's goal of achieving licensing uniformity. The NAIC adopted a uniform application that is used for both resident and non-resident licensing. Thirty-two states and the District of Columbia are using these applications for resident licensing, while forty-eight states and the District of Columbia are using these applications for non-resident licensing. Another example of state uniformity and coordination is the well-established State Producer Licensing Database, which facilitates faster licensing of non-resident applicants, as well as better tracking and coordination of regulatory actions among states. Every state and the District of Columbia participate in this database, which has been the centerpiece for creating greater efficiency in producer licensing and greater consumer protections.
- The NAIC is also moving well beyond the Gramm-Leach-Bliley mandates calling for licensing reciprocity in a paper environment. The NAIC continues to call for licensing uniformity in a modern-day electronic environment that addresses: (1) licensing qualifications, (2) pre-licensing education, (3) producer licensing testing, (4) background checks, (5) application process, (6) appointment process, (7) continuing education requirements, and (8) limited line uniformity.
- The NAIC and state insurance regulators have been working with the Federal Emergency Management Agency (FEMA) to assist it with its mandate contained in Section 207 of Senate Bill 2238. This provision requires the Director of FEMA to work with states and the insurance industry to establish minimum training and continuing education requirements for insurance producers that sell flood Insurance.

Impact of the SMART Act on State Consumer Protections

As currently structured, the draft SMART Act would result in regulatory gaps and market uncertainty

for both insurance companies and consumers because it broadly preempts existing state laws and regulations used to supervise insurance companies and producers. The NAIC and its members know very well from hands-on experience that modernizing complex regulatory rules in these areas must be handled very carefully, with full and ongoing input from regulatory experts, consumers, and industry. Even well-intended and seemingly benign federal laws can have a substantial adverse impact on state laws and regulations that protect insurance consumers if they preempt state regulatory authority. This has already been proven by ERISA regulations and the National Flood Insurance Program.

In December 2004, the NAIC undertook a thorough review and analysis of the draft SMART Act using seven teams of insurance commissioners and senior state staff totaling 117 regulatory experts. The SMART Act's provisions were evaluated to determine their potential impact on the NAIC's modernization roadmap and state regulatory authority. A final version of the NAIC SMART Act Review Team report was transmitted to Chairmen Oxley and Baker on April 22, 2005. The report focuses on concerns about the negative impact of the SMART Act's fundamental structure, which would employ broad federal legal preemptions and second-guessing of state regulatory decisions to achieve its goals.

Here are the summary findings of the NAIC Review Teams report:

- (1) The SMART Act would substantially and negatively impact state regulatory authority to supervise property/casualty, life, and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws. As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.
- (2) The SMART Act would create regulatory confusion in insurance markets by subjecting state regulatory authority to second-guessing and possible interference by a new federal entity called the State-National Insurance Coordination Partnership. In addition to raising a host of serious legal and practical concerns regarding its composition, powers, and administration, this Partnership would encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions. The legitimacy of state actions would hang under a cloud of doubt

until a final resolution is reached in federal courts, causing uncertainty in the marketplace.

- (3) The SMART Act would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in such important areas as supervising rates and conducting market conduct exams. Even in Illinois, which has often been cited by SMART Act proponents as the model rate system for all states, the Act would undercut or negate important provisions of state law that make the Illinois rate system work.
- (4) Most specified time limits for states to implement the SMART Act's requirements are unrealistically short. In addition, many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.
- (5) Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization. However, the NAIC welcomes federal legislation that would permit equal access by all state insurance regulators to the FBI's criminal database, enable sharing of confidential regulatory information, and grant states equal receivership powers with the federal government.

The NAIC wants to play a positive role in helping the Congress evaluate the draft SMART Act by providing technical assistance as regulatory experts and policy input as state officials. However, the NAIC cannot support any federal legislation that includes broad federal preemption of state consumer protection laws or federal supervision of state insurance regulation. Unwise federal interference could undermine or negate state consumer protections, while also causing confusion among insurers, producers, and policyholders concerning "who is in charge" of important regulatory decisions.

As the SMART Act has not yet been formally introduced as a bill, it is premature for the NAIC to take a position to support or oppose it. However, we have expressed the NAIC's fundamental concerns regarding the structure and impact of the SMART Act during meetings and correspondence with Members and staff of the House Financial Services Committee. For these reasons, the NAIC has long expressed concerns about how an optional federal charter for insurance companies would erode state authority and undermine consumer protections.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand the difference between regulatory oversight of personal lines and commercial lines, and are taking necessary steps to modernize regulatory procedures for the benefit of consumers.

We ask Congress and insurance industry participants to work with us to implement the NAIC's modernization initiatives through the state legislative system. We believe that is the most practical way to achieve necessary changes quickly in a manner that preserves state consumer protections for the benefit of consumers. The state process rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

Clearly, local and regional state regulation of insurance is the best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

This article was adapted from testimony given by Commissioner Koken before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the U.S. House Committee on Financial Services on June 26, 2005 in a hearing on "SMART Insurance Reform".

THE NEW ANTI-MONEY LAUNDERING RULES FOR INSURANCE COMPANIES

By: Connie M. Friesen

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On October 31, 2005, the U.S. Treasury Department (the "Treasury"), through the Financial Crimes Enforcement Network ("FinCEN"), announced two final rules requiring certain U.S. insurance companies to establish anti-money laundering ("AML") programs and file Suspicious Activity Reports. Both rules apply to insurance companies that issue or underwrite "covered products" deemed by FinCEN to present a higher degree of risk for money laundering or the financing of terrorism. Such "covered products" include: permanent life insurance policies, other than group life insurance policies; annuity contracts, other

than group annuity contracts; and any other insurance products with cash value or investment features. Notably, certain products are explicitly excluded from the definition of "covered products" because they pose a lower risk for money laundering. These excluded products are group insurance products; products offered by charitable organizations (e.g. charitable annuities); term (including credit) life, property, casualty, health, or title insurance; and reinsurance and retrocession contracts.

Set forth below is a summary of certain of the requirements that insurance companies must meet in order to comply with the new AML rules which become fully applicable on May 2, 2006. 70 Fed. Reg. 66754-66769 (November 3, 2005).

A. Background

On October 26, 2001, the President signed into law the USA PATRIOT Act.¹ Section 352 of the USA PATRIOT Act requires that all entities defined as financial institutions under the Bank Secrecy Act, establish formal AML programs. Under the Bank Secrecy Act, an insurance company is defined as a "financial institution". Section 352 of the USA PATRIOT Act also instructs the Secretary of the Treasury to prescribe regulations for AML programs that are proportionate with the size, location and activities of the financial institutions to which these regulations apply. However, at a minimum, every AML program is required to include: the development of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to measure the program's effectiveness.²

Insurance companies were originally required to establish their AML programs by April 2002. However, FinCEN, pursuant to authority granted to it under the USA PATRIOT Act, deferred the issuance of rules to implement this requirement, giving FinCEN an opportunity to study the insurance industry and consider how best to apply AML requirements to the industry.³ FinCEN has now issued two separate final rules addressing AML compliance by insurance companies. 31 C.F.R. 131.137 identifies the types of insurance companies that must create AML programs, and sets forth the minimum requirements for those programs and the consequences of failure to comply with this rule (hereinafter the "AML Program Rule"). 31 C.F.R. 103.16 requires those insurance companies that are required to establish AML programs to iden-

¹ Pub. L.107-56 (October 26, 2001).

² 31 U.S.C. § 5318(h)(1).

³ 31 CFR 103.137.

tify and report suspicious transactions to FinCEN (hereinafter, the “SAR Program Rule”).⁴

B. Covered Products

In determining which insurance companies must establish AML programs, FinCEN has made a distinction between higher and lower risk insurance products. In its explanation of the final rule, FinCEN sets out examples of insurance products that pose a high and a low risk of being used for money laundering. For example, life insurance policies that have a cash surrender value are said to pose a money laundering risk because the cash value can be redeemed by a money launderer or can be used as a source of further investment of tainted funds. Annuity contracts can also pose a money laundering risk because they allow a money launderer to exchange illicit funds for an immediate or deferred income stream or to purchase a deferred annuity and receive clean funds upon redemption. In contrast, with reinsurance and retrocession contracts and treaties, where insurance companies reallocate risks within the industry, there is very little risk of money laundering because there is no customer interaction. Additionally, the threat of money laundering in group life insurance policies and group annuities is minimal because those plans are generally issued to a company or financial institution and typically restrict the ability of participants to manipulate their investments. Therefore, FinCEN has not required issuers of group life insurance or group annuity policies to establish AML programs or file Suspicious Activity Reports under the rules. FinCEN also decided to exclude term life insurance policies from the AML program requirements because the absence of a cash surrender value and the underwriting scrutiny given to term policies made the money laundering risks associated with such products low.

The AML Program Rule defines the term “covered product” to mean: “(i) a permanent life insurance policy, other than a group life insurance policy; (ii) any annuity contract, other than a group annuity contract; and (iii) any other insurance product with features of cash value or investment.”⁵ The definition incorporates a functional approach to the definition of a “covered product” and includes any insurance product that has the same kinds of features that cause permanent life

insurance and annuity products to present a higher risk of being used for money laundering.⁶

Although both the AML Program Rule and the SAR Rule deal with the same set of insurance products, the AML Program Rule outlines the requirements for an insurance company’s total AML program, while the SAR Rule specifically addresses an insurance company’s required reporting of suspicious activities.

C. AML Program Rule

The AML Program Rule requires that, not later than May 2, 2006 “each insurance company issuing or underwriting a covered product [must] develop and implement an AML program reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities.”⁷ The AML program must be in writing, approved by senior management, and must be made available to FinCEN upon request. Additionally, FinCEN notes that while some insurance companies may choose to adopt a company-wide anti-money laundering program, the final rule requires only that “covered products” (as defined above) be included in such a program. Therefore, if an insurance company offers a variety of insurance products, the AML program requirements apply only to those products covered by the AML Program Rule.

1. Treatment of Agents and Brokers

Under the terms of the AML Program Rule, the requirement to establish an AML program applies to an insurance company, but not to its agents or brokers. FinCEN provides several reasons for this distinction. First, because the insurance company develops its products, the insurance company should be responsible for making certain that these products do not facilitate money laundering. Second, as compared to individual agents and brokers, insurance companies are better able to bear the cost of compliance with these requirements. Finally, many insurers already have compliance programs and best practice guidelines set up for their agents and brokers that would assist in compliance with this rule.

Nonetheless, brokers and agents are assigned important AML responsibilities. Each insurance company covered by the AML Program Rule must establish

⁴ See 31 CFR 103.137. The final rule requiring the establishment of an AML program states that “Published elsewhere in a separate part of the *Federal Register* is a final rule requiring insurance companies to file Suspicious Activity Reports. That final rule applies to the same universe of insurance companies and covered products as this final rule.”

⁵ 31 CFR 103.137(a).

⁶ Although when this rule was proposed, some comments suggested that there be a dollar threshold exemption for life insurance policies, FinCEN

has rejected this idea. Under the USA Patriot Act, a risk-based approach should be used to create all AML programs. Therefore, the dollar amount involved in the issuing or underwriting of certain products should not be considered in isolation but among other factors in developing the AML program.

⁷ 31 CFR 103.137(b).

policies and procedures designed to integrate its agents and brokers into the insurance company's AML program. An insurance company may also assign important know-your-customer responsibilities to its agents and brokers.

Additionally, the AML Program Rule notes that because insurance companies typically conduct sales operations through their brokers or agents, some elements of the compliance program may be performed best by such brokers or agents. It is interesting to note that FinCEN explicitly states that if the effectiveness of the rule is undermined by a lack of cooperation on the part of the agents or brokers, FinCEN will consider amending the AML Program Rule to assign greater responsibilities to agents and brokers.

2. *Minimum AML Program Requirements*

The AML Program Rule sets out minimum requirements that must be met for an acceptable AML program.⁸ However, beyond the minimum requirements, insurance companies are given flexibility to design programs that meet their specific business risks and needs. In developing an AML program, an insurance company is expected to consider all relevant factors affecting the risks inherent in its insurance products. For example, an insurance company should consider the extent and the circumstances under which its customers use cash or cash equivalents to purchase a covered product. Additionally, an insurance company should consider whether it issues or underwrites covered products to persons whose country has been identified by the State Department as a sponsor of international terrorism. Similarly, an insurance company should consider whether the purchaser's country has been designated by the Financial Action Task Force ("FATF") as a non-cooperative country or territory ("NCCT") or whether the purchaser's country has been found by the Secretary of the Treasury or the Director of FinCEN to require that special measures be taken due to AML concerns.

The AML Program Rule requires designation of a compliance officer to be in charge of administering an insurance company's program.⁹ The compliance officer is responsible for making certain that the AML program is being implemented effectively and updated as necessary. The compliance officer is also responsible for making certain that appropriate persons are trained to detect suspicious activity.

Employee training is another requirement of the AML Program Rule.¹⁰ The nature and scope of the

training will vary depending on the specific products and AML risk profile of an individual insurance company. The AML Program Rule also requires that an insurance company provide training for its insurance agents and brokers regarding their responsibilities under the company's AML program. An insurance company can satisfy this obligation by either training its agents and brokers directly or by verifying that its agents and brokers have had appropriate AML training provided by a "competent third party". A "competent third party" could include an independent vendor or another financial institution that is also subject to AML program requirements.

An insurance company is also required to provide for independent testing of its AML program on a periodic basis.¹¹ The tests do not need to be performed by an accountant or outside consultant; an employee of the insurance company can perform the tests as long as that employee is not the compliance officer or otherwise connected with the administration of the program. Any recommendations made as a result of the independent testing process must be implemented promptly or submitted to management for consideration.

3. *Insurance Companies that are Registered Broker-Dealers*

An insurance company that is required to register as a broker-dealer with the Securities and Exchange Commission (SEC) and has already implemented an AML program pursuant to SEC requirements will be deemed to be in compliance with the AML Program Rule, except to the extent that the AML Program Rule contains provisions not required by the SEC.¹² Additionally, this provision applies only to an insurance company that is itself required to register with the SEC as a broker-dealer in securities. It does not apply to a registered broker-dealer that only distributes an insurance company's products.

4. *Responsibilities of FinCEN*

The AML Program Rule explicitly states that FinCEN or its delegates shall examine insurance companies for its compliance with this Rule.¹³

D. Suspicious Activity Reports for Insurance Companies

The SAR Rule requires insurance companies to identify suspicious activities and file Suspicious Activity Reports as necessary. Insurance companies must comply with the SAR Rule no later than May 2, 2006. Previously, an insurance company would alert authori-

⁸ 31 CFR 103.137(c).

⁹ 31 CFR 103.137(c)(2).

¹⁰ 31 CFR 103.137(c)(3).

¹¹ 31 CFR 103.137(c)(4).

¹² 31 CFR 103.137(d).

¹³ 31 CFR 103.137(e).

ties to suspicious activity by checking a box on Form 8300, signifying a suspicious transaction.¹⁴ The SAR Rule, however, requires insurance companies to report suspicious transactions on new FinCEN Form 108.¹⁵ A reportable suspicious activity must involve at least \$5,000. However, it should be noted that this amount includes a policy in which the premium or potential payout reaches the \$5,000 mark.

FinCEN has identified several activities that would be considered “suspicious” and thus would require an insurance company to fill out a Suspicious Activity Report. So-called “red flag” activities include: the purchase of an insurance product inconsistent with the customer’s needs; unusual payment methods, such as cash or cash equivalents where they are not typical; early termination of a product at a cost to the customer; payment made by an unrelated third party; customers showing little concern for the investment performance of a product and great concern over early termination features and customers who provide little or false information about themselves before investing.

1. *Treatment of Agents and Brokers*

Like the AML Program rule, the requirement to identify and report suspicious transactions applies only to the insurance company, not its agents or brokers. FinCEN lists several reasons for placing the responsibility to report suspicious activity on the insurance company rather than the individual broker and agent. Its reasoning parallels the explanation given in the AML Program rule. FinCEN states that the insurance company should shoulder the responsibility of reporting suspicious activity because it would have developed the product giving rise to the suspicious activity. Additionally, due to its size, an insurance company is in a better position to bear the costs of compliance than agents or brokers.

2. *Joint Suspicious Activity Report Filings*

FinCEN has also noted that under the SAR Rule, joint Suspicious Activity Reports are permissible where two or more financial institutions, both subject to suspicious activity reporting requirements are involved in a common or related transaction. As long as each financial institution has information regarding the transaction, a joint report may be filed. The report will

¹⁴ Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade of Business) is a form required to be filed by insurance companies to report the receipt of cash over \$10,000. Insurance companies should continue to file Form 8300 when they have received cash over \$10,000 even if they also must file a Suspicious Activity Report. An insurance company required to file a Suspicious Activity Report is not precluded from checking Box 1b on Form 8300 to alert authorities of a suspicious transaction but they must also file the Suspicious Activity Report.

be deemed to have been filed by each financial institution involved in the underlying transaction.

E. Actions to be Taken by Insurance Companies

It is now very clear that insurance companies offering “covered products” must adopt AML programs, policies and procedures that meet the requirements of the AML Program Rule and the SAR Rule. Such programs will need to be risk-focused with particular emphasis on activities deemed to be “high risk” by FinCEN. Insurance companies will also be required to file Suspicious Activity Reports as necessary.

It will be important for insurance companies covered by these new rules to review and revise any existing AML policies and procedures in order to make certain that they are fully consistent with the AML Program Rule and the SAR Rule. For insurance companies that may not yet have fully implemented the applicable AML requirements of the USA PATRIOT Act, immediate action is now imperative.

INSURANCE DISASTER RISK: A NATIONAL CATASTROPHE INSURANCE PROGRAM IS PROPOSED

On August 29, 2005, Hurricane Katrina struck the Gulf of Mexico causing estimated insured losses of \$35 billion or higher, thereby becoming the costliest insured loss from a single event in U.S. history and easily surpassing Hurricane Andrew’s insured losses of \$15.5 billion in 1992. With hurricanes Rita and Wilma also hitting the U.S. this year and hurricanes Charley, Frances, Ivan and Jeanne hitting the Florida coast in 2004, it is evident why insurance regulators and companies are now again looking much more closely at the feasibility of establishing a national catastrophe insurance program. According to the Insurance Information Institute, seven of the ten most costly hurricanes in US history have occurred in the fourteen-month period from August, 2004 to October, 2005.

In mid-November of this year, a National Catastrophe Insurance Summit was held in Burlingame, California hosted by Commissioner John Garamendi of California, Kevin McCarthy, Florida Insurance Commissioner, Michael McRaith, Illinois Insurance Director and Howard Mills, New York Superintendent of Insurance. The four commissioners proposed eliminat-

¹⁵ FinCEN Form 108 (Suspicious Activity Report by Insurance Companies) is not yet published and effective. Until the time that FinCEN Form 108 is published and effective, insurance companies may use FinCEN Form 101 (Suspicious Activity Report by the Securities and Futures Industries) to report any suspicious activity.

ing the National Flood Insurance Program and developing state catastrophe funds similar to Florida's Hurricane Catastrophe Fund (FHCF), which was created in 1993 after Hurricane Andrew. The FHCF is a tax-exempt trust fund which provides reinsurance to insurers in Florida for a portion of their catastrophic hurricane losses. In the event the FHCF needs additional funding it can issue tax-exempt bonds which are repayable from reserve funds and assessments.

The NAIC commissioners also proposed creating a federal backstop for insurers, providing tax deferments for insurers to help build a fund earmarked for catastrophic events and forming a national commission that would help to determine premiums based on actuarial data. Florida Insurance Commissioner McCarty commented: "We need a comprehensive federal solution that pre-funds future catastrophic losses, not funding after the event using the federal deficit". Superintendent Mills also remarked: "It is important that we plan ahead to be in a position to respond nationally to the financial consequences of major catastrophes, accumulating funds in both the private and public sectors to pay for extraordinary losses". In spite of the widespread agreement on the nature and scope of the problem, the summit did not reach agreement about such major issues as the nature of the support to be provided by the federal government and as to when federal involvement would be triggered.

The economic effects of the recent hurricanes will continue to be felt. Most analysts predict that Hurricane Katrina and the other hurricane losses will result in higher insurance premiums and much more restricted coverage in coastal areas that are likely to be hit by hurricanes. Some insurers have announced plans to curtail or withdraw from hurricane-prone areas. Many homeowners in coastal areas are not covered by flood insurance and only 13% of California homeowners in earthquake-prone areas are covered by earthquake insurance. According to a September 15, 2005 report of the Congressional Research Service, "Estimates of the probable maximum losses (PMLs) from a catastrophic earthquake or hurricane striking the U.S. range up to \$120 billion, and this figure could be even higher depending on the location, time and intensity of the event. The PML loss from a Category 5

hurricane directly hitting a densely populated area along the Gulf and Atlantic coasts (e.g., Miami-Ft. Lauderdale) could exceed the total capacity (policyholder surplus) of the U.S. insurance industry".

Congress has considered legislative proposals to establish federal disaster insurance or reinsurance programs for over thirty years, but the only ones which have been enacted are the National Flood Insurance Program and the Terrorism Reinsurance Act of 2002. In November, Congress expanded the borrowing authority of the National Flood Insurance Program to \$18.5 billion to cover existing flood claims. In the current session of Congress, Congressman Foley of Florida and several other congressmen have introduced the Policyholder Disaster Protection Act of 2005 (H.R. 2668) which amends the Internal Revenue Code of 1986 to permit insurers to establish tax-deductible reserve funds for catastrophes. Representative Ginny Brown-Waite has introduced the Homeowners' Insurance Availability Act of 2005 (H.R. 846) which would provide catastrophe reinsurance to state insurance programs and private insurers.

It will be interesting to observe whether the NAIC-state based initiative to develop a national catastrophic insurance program will gain traction in light of the ongoing debate as to the appropriate role of the federal government in the handling and financing of catastrophic risk. Prior to 1989, the insurance industry had not experienced losses from a single disaster which exceeded \$1 billion. From 1992 to present, the insurance industry has experienced eleven losses which have exceeded \$2.9 billion and four losses which have exceeded \$12.5 billion. According to the Insurance Information Institute, the year 2005 will be by far the worst year ever for insured catastrophe losses in the U.S. (currently totaling \$56.8 billion) — more than twice 2004's record. In view of the increasing frequency and severity of catastrophic events, the possible effects of climate change and the probability that catastrophes will strike in areas of high population density and where there is a concentration of economic resources (e.g., oil refineries and offshore drilling rigs and platforms in the Gulf Coast) the development and implementation of a national catastrophe insurance program may be a lot closer.

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