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INSURANCE REGULATION

Scandal Highlights Need for States to Strengthen Regulatory Oversight

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Scandal Highlights Need for States to Strengthen Regulatory Oversight

Martin Frankel, a banned securities broker who allegedly migrated from that industry to the insurance industry is under indictment for embezzling more than $200 million in insurance company assets over a nearly 8-year period. Mr. Frankel has not yet been convicted in the United States and others are currently under investigation for assisting him.

This statement focuses on three issues: (1) how the scam happened, (2) the regulatory weaknesses exposed by this scam, and (3) the crucial importance of regulatory information sharing.

What happened? Throughout the 1990s, Martin Frankel, with assistance from others, allegedly obtained secret control of entities in both the insurance and securities industries. He is accused of secretly purchasing 7 insurance companies in several states. Using a securities firm as a front, Mr. Frankel then allegedly took custody of insurance company assets and provided false documents on investment activity to disguise his actual purpose. Instead of managing these assets in a prudent manner, he allegedly diverted them to other accounts he controlled and used them to support the ongoing scam and his lifestyle.

What are the regulatory weaknesses? We observed regulatory weaknesses in multiple states over several years during key phases of insurance regulatory oversight. Specifically, we observed inadequate measures for assessing the appropriateness of buyers of insurance companies, analyzing securities investments, evaluating the appropriateness of asset custodians, verifying the insurers' assets, and sharing information within and outside the insurance industry. We also found some weaknesses in support services provided by the National Association of Insurance Commissioners (NAIC).

What improvements in the sharing of regulatory information are needed? Information sharing failures existed between state insurance departments and other state and federal regulators, including state securities departments, as well as among state insurance department in different states. As highlighted in the Gramm-Leach-Bliley Act, the importance of regulatory information sharing is greater than ever before. The fraudulent activities allegedly perpetrated by Mr. Frankel further demonstrate the need for heightened coordination of oversight activities among regulators in cases where affiliated entities exist.

The insurance industry has recognized its weaknesses and has proposed corrective actions. This statement also contains a number of GAO recommendations, which regulatory agencies generally endorsed.

Statement

Scandal Highlights Need for States to Strengthen Regulatory Oversight

Mr. Chairman and Members of the Subcommittee

We are pleased to be here to discuss with you our report on insurance regulation that is being released today.[1] My testimony today focuses on three issues. First, how did the scam allegedly used by Martin Frankel to steal over $200 million from several insurance companies across the country operate? Second, what are some of the regulatory weaknesses exposed by the scam? These regulatory weaknesses allowed Mr. Frankel to gain control of seven insurers domiciled or chartered in six different states, and delayed detection of the alleged theft for as much as 8 years—greatly increasing the size of the loss. Finally, we will talk about the crucial importance of regulatory information sharing—both in the context of the failure to uncover the Frankel scam and in the broader context of a world with affiliations of financial firms across industry boundaries as permitted by Gramm-Leach-Bliley.

I should note that Mr. Frankel, while currently being held by German authorities and facing extradition to the United States, has not yet been convicted in the U.S. for any of the actions that are attributed to him. At present, these actions are alleged to have been committed by him. Similarly, Mr. Frankel acted with assistance from others. A few of his associates have admitted to roles in Mr. Frankel's alleged scam, and others are under investigation. As yet, the whole story has not been told.

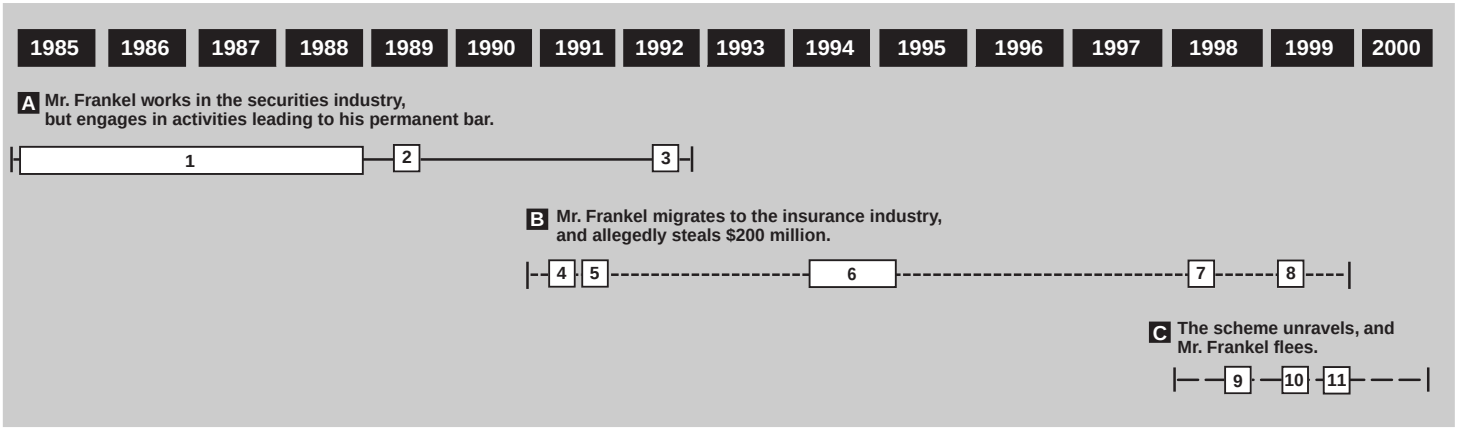
The Scam

In the 1980s Martin Frankel worked in the securities industry. He was permanently banned from the securities industry by SEC in 1992. Even prior to his removal from the securities industry, he was setting up the mechanism to move into the insurance industry. He allegedly gained secret control of a small securities firm called Liberty National Securities (LNS), which in 1991, a year before his ban from the securities industry, he directed to become registered with the state securities department in Tennessee. The same year, he allegedly anonymously established an entity known as Thunor Trust, using the names of nominee grantors as the apparent source of the money. Thunor Trust then applied for regulatory approval from the Tennessee Department of Commerce and Insurance, Division of Insurance, to purchase the Franklin American Life Insurance Company, a small, financially weak insurer. This application was subsequently approved. In this and all subsequent interactions with the insurers or with regulators, Mr. Frankel's name was never used. He always

[1] Scandal Highlights Need for Strengthened Regulatory Oversight (GAO/GGD-00-198, Sept.19, 2000).

operated by using aliases or through fronts. See figure 1 for a timeline showing the actions of Mr. Frankel and Thunor Trust between 1985 and 1999.

Figure 1: Overview of the Scandal



A

1 1985-1988, Mr. Frankel works in the securities industry and is fired from two firms for personal differences with management and activities subsequently leading to an SEC investigation.

2 December 1989, SEC begins a formal investigation of Mr. Frankel for omissions and misstatements to investors about his investment practices.

3 August 1992, Mr. Frankel settles with SEC and is permanently barred from the securities industry.

B

4 August 1991, Liberty National Securities registers in Tennessee and is allegedly controlled by Mr. Frankel.

5 September 1991, Mr. Frankel allegedly forms Thunor Trust using nominee grantors and files application and later buys a Tennessee Insurance company.

6 February 1994 - March 1995, Thunor Trust purchases 4 more insurance companies domiciled in Mississippi, Oklahoma, and Missouri.

7 February 1998, Thunor Trust purchases an insurance company domiciled in Alabama.

8 February 1999, Thunor Trust purchases an insurance company domiciled in Arkansas.

C

9 Late 1998, Tennessee and Mississippi insurance regulators became suspicious of insurers' asset custody arrangements.

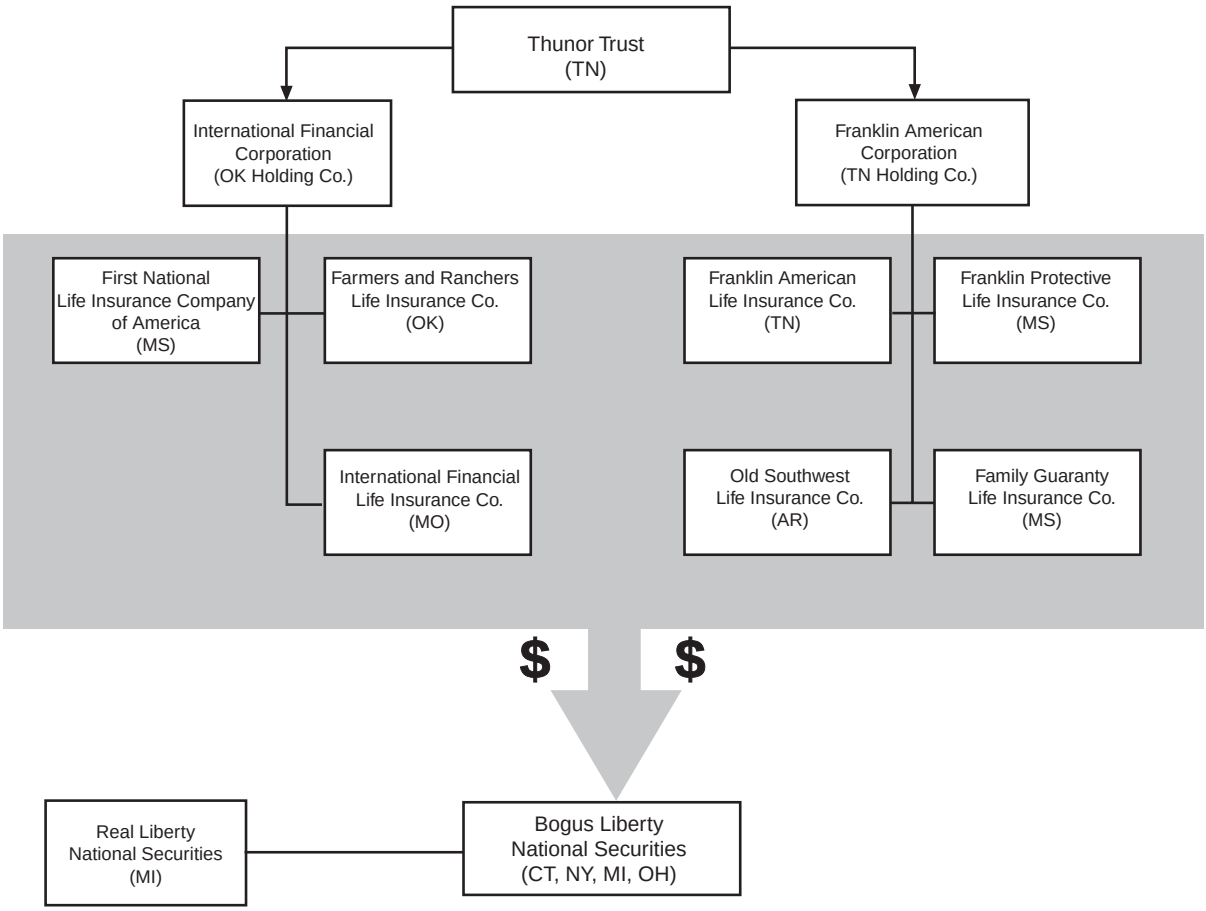
10 Early May 1999, Mr. Frankel flees the U.S.

11 September - October 1999, Mr. Frankel is arrested in Germany and then indicted in federal court in Connecticut.

Source: GAO.

Over the next 8 years, Thunor Trust purchased six more insurance companies domiciled in five additional states. All of the insurance companies owned by Thunor Trust were managed out of the Franklin American headquarters in Franklin, Tennessee, even though they continued to be domiciled for regulatory purposes in the states of Mississippi, Oklahoma, Missouri, Alabama, and Arkansas. The insurer bought by Thunor Trust in Alabama was later redomesticated (moved) for regulatory purposes to Mississippi, even though it continued to be operated out of Tennessee. Figure 2 provides an overview of the Thunor Trust companies and their states of domicile when the scam collapsed.

Figure 2: Simplified Structure of the Thunor Trust Insurance Companies



Source: GAO summary of insurance regulatory data.

Mr. Frankel allegedly used the same scheme to loot each of the insurance companies. After purchasing a company, Frankel removed the company's assets from the control of the insurance company, using LNS as a front. Shortly after Thunor Trust purchased an insurer, the company's assets would all be sold and apparently replaced with government bonds purchased on the insurer's behalf by LNS, acting under the direction of Mr. Frankel who operated using an alias. None of this activity involved the real LNS; rather, it was carried out by a bogus LNS operated by Mr. Frankel out of his mansion in Connecticut.

In actuality, the companies lost control of their assets when the money was turned over to LNS. Mr. Frankel's bogus company, using the name of the firm he secretly controlled—that is—the real LNS, provided monthly statements to each insurance company detailing a very active trading strategy and showing the bonds that were supposedly bought and sold that month by LNS as agent for the insurer. According to these statements, the bond trading was profitable, and the profits were returned to the company. In fact, the securities transactions shown on these statements did not happen. The statements were fabrications. It appears that Mr. Frankel actually used the company's assets to (1) return phony profits to the company, (2) purchase additional insurance companies—a necessary step to continue the fraud, and (3) support his own lavish lifestyle. Ultimately, taxpayers, other insurers, and certain policyholders will bear much of the losses resulting from the scam.

Regulatory Weaknesses

Overseeing the financial health of insurance companies can be broken down into three key phases—change of ownership approval, routine financial analyses, and on-site examinations. We observed regulatory weaknesses in each of these phases in all the states where Frankel allegedly purchased insurance companies, as well as with certain support services provided to the states by the National Association of Insurance Commissioners (NAIC). Table 1 summarizes the weaknesses we identified in each of the phases of regulatory oversight.

Table 1: Overview of Regulatory Weaknesses

Oversight phase	Weakness	Specific observations
Change in ownership approvals	*Inadequate due diligence performed on buyer application data*	- Failure to act on "red flags" associated with trust managed by a sole and irrevocable trustee that left grantors with no control over money - Inadequate questioning of prospective buyers
	Inadequate tools and procedures to validate individuals' regulatory or criminal backgrounds	- Inability to readily access regulatory history data - Inability to access criminal history data on individuals
	Lack of coordination between regulators within and outside the insurance industry	- Failure to exchange insurance regulatory concerns among states on a timely basis - Absence of an industry "clearinghouse" of insurer application data - Inability to routinely access data from other financial regulators
Routine financial analyses	*Inadequate analysis of securities investments*	- Inadequate state procedures and practices to flag high asset turnover ratios and no use of thresholds to trigger additional scrutiny - Lack of NAIC policies, procedures, or practices to assess asset turnover - Insufficient securities expertise exhibited by insurance departments to question unusual investment strategy - Lack of NAIC consolidated financial analysis of affiliated insurers in multiple states
	Ineffective mechanisms to safeguard and monitor control of insurers' securities held by another entity	- Inconsistent and ineffective policies regarding appropriate asset custodial relationships - Failure of insurance regulators to require from insurers sufficient information to allow independent verification of legitimacy and appropriateness of new custodians - Inadequate information collected annually to understand who had control of the insurers' assets
	Inadequate securities-related expertise and information gathering	- Lack of expertise to assess the viability of the insurers' investment strategy - Failure to obtain securities-related expertise from state securities regulators or from contracted assistance - Lack of communication with state securities regulators to verify the appropriateness and legitimacy of the broker-dealer
On-site examinations	*Failure to detect misappropriation of assets*	- Failure of four completed exams on companies owned by Thunor Trust to identify any material weaknesses - Inadequate examination guidelines and procedures to verify book-entry securities that were not held by a depository institution - Inadequate assessment of highly unusual investment activities - Questionable ability of insurance examiners to assess securities related activities
	Inadequate practices and procedures to verify the legitimacy of asset custodians	- Inadequate efforts to independently validate the identity and appropriateness of the asset custodian - Improperly executed custodial agreements not detected
	Limited sharing of Information and coordination among regulators	- Lack of proactive alerts to warn other states of examination concerns so as to deter scam from spreading - Lack of communication with securities regulators - Lack of coordinated on-site examinations for insurers in the same group

Source: GAO analysis of insurance regulatory data.

In some cases, the identified weakness involved a lack of the appropriate policies and procedures for identifying problems in the Thunor Trust insurers. At other times, state insurance regulators failed to follow existing policies, procedures, or recommended practices. Overall, however, regulators did not act in response to "red flags" raised by the actions of Thunor Trust, the insurance companies, or the bogus LNS that served as "custodian" of the insurance company assets. These red flags did not necessarily rise to the level of illegality. But individually, and certainly collectively, they should have led regulators to ask more and harder questions—the answers to which very likely would have uncovered the scam much sooner. We believe that all financial regulators, including state insurance regulators, have a positive responsibility to act with professional skepticism. It is clear that for many years, in this case, insurance regulators did not.

Our report on the regulatory handling of the insurance companies was requested by the Ranking Member of the full Committee, Mr. Dingell, and was released this morning.[2] It provides considerable detail on each of the regulatory weaknesses identified in table 1. In my statement today, I would like to mention only a few of the more egregious examples.

During the initial change of ownership process when Thunor Trust applied to purchase its first insurance company, Franklin American Life Insurance Company, there is no indication that Tennessee insurance regulators noted any of the peculiarities or followed up with any detailed information gathering about the potential buyer. There were several unusual circumstances that could have sparked additional regulatory scrutiny. These included the fact that Thunor Trust was newly created and had no track record in the insurance industry. Moreover, the trust was established in such a way that the grantors had no control over how their money was to be used. The trust was managed by a single trustee, not one of the grantors, whose authority was irrevocable, even by the grantors, irrespective of performance. In spite of these unusual circumstances, the three grantors of the trust, those supposedly putting up the money, were never questioned, nor did we find any evidence that regulatory and criminal history background checks were performed.

Each of these and other characteristics of the trust arrangement should have raised red flags for regulators exercising professional skepticism. The federal indictment now alleges that Frankel himself established the trust, using the names of three acquaintances who never actually

[2] Scandal Highlights Need for Strengthened Regulatory Oversight (GAO/GGD-00-198, Sept.19, 2000).

contributed funds to the trust. As the sole purpose of the trust,was to purchase insurance companies, had regulators followed the money trail back to the reported sources of origin and questioned the grantors directly to validate their interests and actual control of the trust, the scam could have been uncovered at the very beginning. Moreover, there is no evidence that any state insurance regulator pursued any of these questions with the grantors of Thunor Trust when it subsequently applied to purchase insurance companies in other states.

Routine financial analysis is the analysis of annual and quarterly financial statements provided to regulators by insurance companies. These financial statements are extensive compilations of data that are used by regulators to monitor the condition and performance of insurance companies, especially those companies for which a particular state insurance department has primary regulatory responsibility, that is, their domiciliary companies. Routine financial analysis is particularly important because of the normal 3-5 year cycle for on-site examinations.

One of the peculiar characteristics of the scam was the nature of the securities activities that were reported by Thunor Trust insurers to their regulators. These activities supposedly consisted of a very active trading strategy using U. S. government bonds. During our review, we found little evidence that insurance regulators recognized or acted on concerns about the massive asset trading activity and the resulting extraordinary asset turnover ratios being reported by the Thunor Trust insurers. NAIC, which provides analytical assistance to states in the form of ratio analysis and other tools, also did not identify or address the companies' investment strategy as a problem. Similarly, the consistently greater-than-normal returns on government bond trading reported on the companies' financial statements failed to generate any regulatory skepticism or concern.

From information provided in the company financial statements filed with NAIC and the state insurance departments, we performed a simple financial ratio test structured to flag highly speculative trading activity—also referred to as an asset turnover test. The results of this analysis, highlighting the unusually high asset turnover activity, are presented in table 2.[3]

[3] This calculation method consisted of the company schedule showing assets acquired and sold each year as the numerator and total company assets as the denominator. This method was selected for illustration because it could be performed easily (or roughly estimated by visual inspection) by regulatory financial analysts. The end of calendar year numbers were used for six of the insurance company submissions during the period the companies were allegedly under Frankel's control. The remaining company, domiciled in Arkansas, was acquired shortly before the collapse of the scam, and

Table 2: Summary of Asset Turnover Ratios

Life insurance company (domicile state)	Time period (calendar year)	Asset turnover ratio (end of year average)	Asset turnover ratio (end of year range)
Franklin American (TN)	1992-98	85	10-207
International Financial Services (MO)	1994-98	54	12-115
First National of America (MS)	1998	27	27
Franklin Protective (MS)	1995-98	89	30-124
Family Guaranty (MS)	1994-98	113	30-193
Farmers and Ranchers (OK)	1994-98	119	29-204

Source: GAO analysis of insurer financial data in the annual statements.

For perspective, an asset turnover ratio of 52 would equate to selling and buying the entire value of the companies' assets weekly. By contrast, a mutual fund expert recently cited concern about equity fund managers whose asset turnovers now average about 0.9.[4]

In April 2000, NAIC officials advised us that new ratio tests to flag possible speculative asset investment activities had been developed and implemented. The threshold test for indicating abnormal investment activity is now an asset turnover of 0.25, about one-fortieth of the lowest asset turnover ratio shown for the companies in table 2.

On-site regulatory examinations of insurance companies usually take place on a 3-to-5 year cycle. Over the years that Thunor Trust owned insurance companies, the various state regulators completed four examinations on several companies. The states have told us that these examination were done in accordance with NAIC's examination guidelines. In no case were any material weaknesses identified, even though it is now alleged that Frankel embezzled the insurers' assets shortly after the companies were purchased by Thunor Trust. In every examination, the principal weakness was the examination's failure to independently verify that the companies had control over their assets, or even that those assets actually existed. Similarly, the examinations failed to independently verify the identity and appropriateness of the asset custodian reported by the companies.

Regulatory Information Sharing

At nearly every stage of the scam that we have described for you today, regulators could have exposed the fraud sooner and limited the damage if there had been better and more consistent sharing of regulatory information. Information sharing failures existed between state insurance

regulators had not yet received a quarterly statement for the period that the insurer was under Thunor Trust.

[4] Wall Street Journal, June 20, 2000.

departments and other state and federal regulators, including state securities departments, as well as among state insurance departments in different states.

For example, in the initial change of ownership process, insurance regulators could have used information on the disciplinary history of the supposed grantors of Thunor Trust. Even though Mr. Frankel's name never appeared, one of the grantors had a history of unfavorable incidents in the securities industry. This information was available on the Central Registration Depository (CRD) maintained by NASD. The CRD entries would not necessarily have been serious enough to preclude the person's association with an insurance company. However, if insurance regulators had talked to the grantors, regulators may have learned that the grantors did not provide any funds for the trust. This level of initial regulatory follow-up could have aborted the scam at its inception.

When questions concerning an insurer's investment activities did arise, insurance regulators did not generally seek regulatory data or expertise from regulators in the securities industry. A check with state securities offices of basic information on Liberty National Securities at any point throughout the 1990s could have helped unravel the investment scam. However, during our review, we did not find evidence that state insurance regulators obtained information from state securities offices during examinations completed in the mid-1990s or while conducting their annual reviews. Nor did we find that NAIC guidelines required such coordination. During our review, we collected information from several state securities offices on the real LNS that revealed major inconsistencies with the information that insurance regulators had been provided on LNS by their domiciled insurers. We reviewed information from the state securities offices on the real LNS through annual statements on file and information contained in the CRD system.

The CRD information, which was available to state insurance regulators through their state securities offices during the entire period of the scam, would have revealed that the real LNS was located in Dundee, MI, contrary to the location on the account statements insurers received from LNS. Additionally, financial statements available in state securities offices revealed that the real LNS typically had reported assets of less than $100,000 during the 1990s. Such information alone could have generated other red flags given the high level of trading that was being reported in the account statements that insurers were receiving from LNS. In addition, a check into the officers of the real LNS would have revealed an inconsistency between those actually employed by LNS and the name of an

individual who was supposedly signing the asset verification documents used by state insurance regulators and a CPA firm.

Two actions taken by Thunor Trust or its insurance companies near the end of the scam clearly illustrate the inadequacy of information sharing between state insurance departments. These actions were the purchase by Thunor Trust of Old Southwest Life Insurance and a reinsurance transaction between First National Life Insurance Company of America and Settlers Life, a Virginia company. Prior to the approval to purchase Old Southwest Life in late February 1999, regulators in Tennessee were warned that Franklin American Life, the company that intended to purchase Old Southwest, might have been looted of its assets. However, this information was not conveyed to regulators in Arkansas, who approved the Old Southwest acquisition. The insurer subsequently experienced losses of over $5 million out of its $6 million in total assets. Similarly, other insurance regulators were unaware of concerns that regulators in Tennessee and Mississippi had with insurers connected to Thunor Trust in early 1999. In April 1999, Settlers Life in Virginia lost approximately $45 million through a reinsurance transaction with First National Life Insurance Company of America. If Virginia regulators had known in February that an insurer owned by Thunor Trust may have been looted of its assets, they could have asked additional questions and warned their domiciled insurers against entering into transactions with an insurer(s) connected to Thunor Trust without prior regulatory approval. In all, over $50 million was lost because important information concerning the solvency of an insurer was not shared by Tennessee with other states. After learning of the possible theft of assets from its domiciled company, instead of notifying other regulators, the Tennessee Department notified the company that it had to return the assets to a qualifying account within 60 days. While $57 million was returned to Tennessee, it was during that same period that $50 million was stolen from companies in other states.

As highlighted in the Gramm-Leach-Bliley Act, the importance of regulatory information sharing is greater than ever before. This is recognized by the law through a requirement that banking and insurance regulators share information about insurance companies and banks that become affiliated. The fraudulent activities allegedly perpetrated by Mr. Frankel further demonstrate the need for heightened coordination of oversight activities among regulators in cases where affiliated entities exist. Although the legislation is recent, insurance and banking regulators have recognized the need to improve their coordination and have taken or plan to take a number of actions. Generally, the actions consist of establishing formal agreements for sharing of information and creating

working groups for periodic meetings to discuss matters of mutual interest. These regulatory actions are in their infancy, but the expected continued blurring of distinctions and separations in financial markets will require an increased and continuing commitment to enhanced regulatory cooperation in performing oversight.

Insurance regulators and the Securities and Exchange Commission (SEC) have also indicated a desire to move toward more regulatory coordination, although the Gramm-Leach-Bliley Act does not specifically address coordination between securities and insurance regulators. However, SEC officials specifically mentioned that, by statute, they could not use regulatory information from insurance regulators in determining eligibility to license brokers.

In the aftermath of the scandal, we have observed a desire by the states and NAIC to address both the known regulatory and information-sharing weaknesses associated with the scandal as well as other areas of vulnerability. Some corrective actions have already been taken. The other corrective actions proposed to date are also commendable. However, success in implementing them will require continued commitment by NAIC and the states, as some actions are expected to take several years to implement. In some cases, corrective actions will require development of model laws by NAIC, adoption of the new laws by individual state legislatures, and the development and implementation of new regulations by insurance departments. Insurance regulators will need to apply the lessons learned from this scandal to resolve existing regulatory weaknesses and effectively coordinate with their banking and securities counterparts as we enter a new environment where the blurring of historical differences in the financial sectors continues.

Conclusions

Insurance companies in several states lost in excess of $200 million through this investment scam. A fundamental aspect of the scam was the concealment of a secret affiliation alleged to exist between entities in the insurance and securities industries, in which the interests behind the ownership of the insurers as well as the investment entity controlling the insurers' assets were one and the same. The role of Mr. Frankel and others is presently the subject of a federal criminal investigation as well as other state criminal and civil actions. Taxpayers will ultimately bear much of the losses resulting from the scandal, together with policyholders who are not fully covered by their own states' insurance guarantee programs.

Insurance regulators were not prepared to prevent or detect a scam allegedly perpetrated among several insurers for nearly 8 years by a rogue

broker who had migrated into the insurance industry. Although routine regulatory monitoring and examination activities are not designed to proactively look for fraud, there is a regulatory responsibility to be alert for fraud. Additional mechanisms should be in place that are designed to detect possible fraud—so called "red flags" that trigger additional regulatory scrutiny. In the scam allegedly carried out by Mr. Frankel, these red flags included peculiarities with the trust, inconsistencies in regulatory data related to asset custody and control, and the unusual investment activities being reported by insurers. Given these unusual activities and circumstances, even though they were not specifically contrary to law or regulation, insurance regulators could have reacted to the warning signals by judiciously asking additional questions. In a number of circumstances, those questions could have unraveled the scam. Clearly, in this particular case, there was a lack of professional skepticism.

In addition, long-standing information-sharing issues among federal and state financial services regulators further exacerbated the negative impacts of the scam. Insurance regulators had insufficient means for conducting background checks and measures to safeguard and verify the insurers' invested assets. In addition, state insurance regulators apparently did not have or seek sufficient expertise in the area of securities and investments to adequately scrutinize the unusual investment activities being reported to them by the Thunor Trust insurers. Similarly, the most significant information-sharing weakness observed was the inability or failure of insurance regulators to access regulatory information available from the securities industry. At each phase in the oversight process, insurance regulators would have benefited from information available through local state securities regulators to further validate the business transactions between the insurance companies and other individuals and entities. Accessing this information was neither suggested nor required, either by the policies and procedures of insurance departments or of NAIC. Finally, once regulatory concerns finally surfaced, the lack of information sharing among state insurance regulators allowed the scam to spread to other states.

We believe that it is too early to fully assess regulatory oversight coordination efforts emanating from the Gramm-Leach-Bliley Act. However, it is clear that federal and state regulators recognize the need to improve coordination as they begin implementing the financial services modernization legislation. Insurance regulators' future fraud prevention efforts will depend, in part, on the sharing of regulatory data between themselves and the banking and securities industries. Regulators in the banking and insurance industries are taking steps to formalize the

coordination mechanisms through memos of understanding and the establishment of interagency working groups.

We also believe SEC and NAIC are correct in their stated need to improve their coordination. However, beyond the narrow issue of variable annuities, we are unaware of any concrete actions or plans for actions to strengthen coordination. Although the Gramm-Leach-Bliley Act does not specifically address coordination efforts between insurance and securities regulators, we believe that such coordination efforts will become increasingly important as the lines distinguishing the offerings of different financial sectors continue to blur. Moreover, the movement of undesirables from one industry to another would be more easily controlled with better sharing of disciplinary information. Overall, as illustrated by the Frankel case, each of the financial regulators needs to consider regulatory data from other financial sectors to properly oversee the business relationships and transactions between institutions in different financial sectors.

Finally, we recognize the efforts of NAIC and the states in proposing corrective actions. These actions represent an acknowledgment that the weaknesses exposed by this scam need to be corrected. As these corrective actions are implemented, the potential for a similar scam to be successful should be substantially reduced.

Recommendations

As a result of the many weaknesses in regulatory oversight and information sharing uncovered by our work, we are making a number of recommendations in our report. These recommendations are repeated here.

We recommend that state insurance commissioners:

- develop and adopt the appropriate mechanisms to adequately safeguard and verify insurer assets that are not in the physical possession of the insurance company, including requirements for ensuring the appropriateness of asset custodians;

- improve information-sharing by

  -- developing mechanisms for routinely obtaining regulatory data on individuals and firms from other financial services regulators; and

  -- implementing policies and procedures for proactively sharing regulatory concerns with other state insurance departments; and

-- increase the level of securities expertise available to their departments' staff and ensure that insurance analysts and examiners have appropriate training, tools, and procedures to analyze securities assets and to recognize unusual investment strategies.

We recommend that the President of NAIC:

- ensure that the corrective actions identified by the Ad Hoc Task Force on Solvency and Anti-Fraud are implemented as quickly and fully as possible, in particular those which NAIC can accomplish unilaterally;

- ensure that the accreditation program requires the states to have adequate controls for safeguarding and verifying assets that are not in the physical possession of the insurer and to have access to securities-related expertise; and

- supplement existing guidance in financial analysis and examiner handbooks reinforcing the importance of reviewers exercising an appropriate level of professional skepticism and due professional care when indicators of fraud or other irregularities surface.

We recommend that the Chairman, SEC and the President of NAIC:

- increase the attention given to the development of more routine processes and procedures for sharing and communicating information to address common regulatory oversight matters, including efforts to help prevent the migration of rogues between the securities and insurance industries.

We recommend that the United States Attorney General, the President of NAIC, and state insurance commissioners

- work together to establish a mechanism by which state regulators can perform criminal background checks on individuals for the purpose of meeting insurance regulators' responsibilities under the federal insurance fraud prevention provision, 18 U.S.C. § 1033.

Matters For Congressional Consideration

In order to encourage and monitor progress by insurance regulators, Congress may want to consider requesting that NAIC periodically report on the status of corrective actions recommended in this report and by NAIC's Ad Hoc Task Force on Solvency and Anti-Fraud, including a discussion of

- states' adoption of appropriate laws, regulations, and processes to safeguard and verify insurer's assets that are not in the physical possession of the insurer;

- regulators' ability to access criminal history data to meet the requirements of federal insurance fraud prevention requirements, as identified in 18 U.S.C. § 1033; and

- efforts and agreements between insurance regulators and banking and securities regulators to oversee insurance-related entities of affiliated financial institutions, including methods for safeguarding and verifying insurer assets held by an affiliated institution and mechanisms to access individual disciplinary data from other financial services regulators.

Agency Comments

The state and federal agencies and other organizations commenting on our report generally concurred with the report's findings, conclusions, and recommendations.

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Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any questions that you or other members of the Subcommittee may have.

Contact and Acknowledgements

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