United States General Accounting Office

GAO

Report to the Honorable
John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

September 2000

INSURANCE REGULATION

Scandal Highlights Need for Strengthened Regulatory Oversight

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September 19, 2000

The Honorable John D. Dingell
Ranking Minority Member
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Dear Mr. Dingell:

As you requested, this report presents our evaluation of insurance regulatory oversight and information-sharing in the matter of a highly publicized insurance investment scam exposed in May 1999. Under indictment for embezzling more than $200 million in insurance company assets over nearly an 8-year period is Martin Frankel. Mr. Frankel, a former securities broker who was barred from that industry in 1992, allegedly migrated to the insurance industry and continued to operate as a rogue by engaging in illegal activity.

The specific objectives of this report are to (1) describe the alleged scam; (2) evaluate the oversight and information-sharing by insurance regulators; and (3) identify cross-financial-sector coordination issues, including those emanating from the scam relevant to financial regulators' efforts to implement the Gramm-Leach-Bliley (GLB) Act.[1]

Results In Brief

Throughout the 1990s, Martin Frankel, with assistance from others, allegedly obtained secret control of entities in both the insurance and securities industries. He is alleged to have anonymously acquired and controlled insurance companies in several states and, despite being barred from the securities industry, to have exercised secret control over a small securities firm. Using the name of this securities firm, Mr. Frankel 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. The scam was finally exposed after insurance regulators in Mississippi took enforcement action against three of the Frankel-connected insurers by placing them under regulatory supervision. At the time this report was being written, a federal criminal probe against Mr. Frankel was still ongoing.

[1] Pub. L. 106-102 (Nov. 12, 1999).

Weaknesses in key insurance regulatory oversight activities, including inadequate analysis of securities investments and failure to detect the misappropriation of assets, contributed to delays in detecting the investment scam for years. We observed some regulatory weaknesses in multiple states over several years during each of the key phases of insurance regulatory oversight—change of ownership approvals, routine financial analyses, and periodic on-site examinations. 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), a voluntary association of state insurance regulators. Some of these weaknesses were similar to those identified in our previous reports on the insurance regulatory system, including weaknesses in interstate coordination, oversight of entities under holding companies, and gaps in controls to prevent the migration of unscrupulous securities brokers to other sectors of the financial services industry. NAIC and the Tennessee Comptroller of the Treasury have also conducted parallel reviews of the scam and disclosed similar weaknesses along with recommendations for corrective actions. Successful implementation of recommendations emanating from the scandal to improve fraud prevention safeguards will require a sustained, high-level commitment by NAIC and the states.

The GLB Act financial modernization legislation highlights the importance of consultation and information-sharing among federal financial regulators and state insurance regulators when banks and insurance companies are 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, 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 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 enhance 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 GLB Act does not specifically address coordination between securities and insurance regulators.

This report includes recommendations to help prevent or detect similar investment scams in insurance companies by proposing the adoption of appropriate asset custody arrangements, improved asset verification procedures, and the sharing of confidential regulatory information across industries and agencies. In addition to the above recommendations emanating from the Frankel matter, this report contains a recommendation designed to broaden and help sustain cooperation among regulators of different financial services sectors. Agencies responding to the report with comments generally concurred with the report's findings, conclusions, and recommendations. We also suggest that Congress consider requesting periodic status reports on regulatory progress and plans in these areas. Such reports would enable Congress to monitor progress and would encourage states to adopt needed reforms.

Background

In 1999, federal authorities indicted Martin R. Frankel for allegedly masterminding an insurance investment scam. Mr. Frankel is a former securities broker who, following a permanent bar from that industry in the early 1990s, allegedly migrated into the insurance industry where he perpetrated an investment scam. The insurance companies negatively affected by the scam were regulated by individual states. Another entity tied to the scam, a broker-dealer, was subject to regulation in the securities industry. The migration of undesirable persons, or rogues, from one industry to another is one of many issues of concern for financial services regulators that are attempting to implement the GLB Act, legislation aimed at modernizing the financial services industry. As detailed in appendix I, our previous work in the insurance and securities industries highlights some long-standing issues in these industries germane to the fraud allegedly perpetrated by Mr. Frankel.

Martin Frankel Is Charged with Stealing Over $200 Million from Insurance Companies

On October 7, 1999, the United States Attorney's Office in Connecticut announced that "a federal grand jury sitting in Bridgeport, Connecticut returned a thirty-six count indictment against Martin R. Frankel, age 44, formerly of Greenwich, Connecticut, charging him with twenty counts of wire fraud, thirteen counts of money laundering, and one count each of securities fraud, racketeering and conspiracy." The indictment identifies entities in the insurance and securities industries that Frankel allegedly used to steal in excess of $200 million in assets belonging to insurers. In addition to the criminal indictment, federal and state authorities have also filed civil actions to recover assets obtained through Frankel's alleged investment scam. At the time of this report, the criminal and civil cases involving Mr. Frankel were ongoing.

Insurance Companies Are Regulated by the States With Assistance from NAIC

Insurance companies are regulated by the states. In contrast to banking and securities entities (other than national banks) that are subject to dual federal and state oversight, the states are solely responsible for regulating the business of insurance. An insurance company is chartered under the laws of a single state, known as its state of domicile. Insurers can conduct business in multiple states, but the regulator in the insurer's state of domicile is its primary regulator. States in which an insurer is licensed to operate, but in which it is not chartered, typically rely on the company's primary regulator in its state of domicile to oversee the insurer.

States are assisted in their regulatory responsibilities through guidance, model (or recommended) laws and regulations, and information-sharing tools provided by NAIC. NAIC is a voluntary association of the heads of each state insurance department, the District of Columbia, and four U.S. territories. It does not have regulatory authority over the state insurance departments. NAIC provides a national forum for addressing and resolving major insurance issues and for allowing regulators to develop consistent policies on the regulation of insurance when consistency is deemed appropriate. State insurance commissioners created NAIC, in part, to help address problems that differing state-by-state authorities, laws, and regulations can cause as state insurance regulators oversee insurers that operate in more than one state. NAIC serves as a clearinghouse for exchanges of information, provides a structure for interstate cooperation for examinations of multistate insurers, distributes model insurance laws and regulations for consideration by states, and reviews state insurance departments' regulatory activities as part of its national accreditation program.

Insurance Regulation Entails Key Oversight Activities

The oversight activities of state insurance regulators may differ, but each oversees the safety and solvency of insurance companies through key phases of oversight activities, which include

- chartering and change in ownership approvals,[2]
- routine financial analyses, and
- periodic on-site examinations.

Adverse findings in the first phase could result in the refusal to permit a change in ownership. Adverse findings in the other two phases could

[2] Regulators generally require applicants to follow the same process to acquire a charter for a new insurance company or to purchase an existing company. The companies that Mr. Frankel allegedly acquired were all previously owned and operated by others before their purchase by Frankel-controlled entities.

result in a variety of regulatory enforcement actions up to the takeover and/or closure of the company.

The initial oversight activities involve state approval of the proposed new ownership of an insurance company—whether to start a new company or to acquire an existing company. Applicants to form or acquire an insurer apply for approval in the state in which the company will be domiciled.[3] Key information collected to render a decision on the ownership application is submitted on a standard form developed by NAIC known as a Form A. In addition to going through the ownership approval process with the domiciliary state, an insurer may also apply to become licensed in other states where it seeks to conduct business.

After a domiciliary state has approved an ownership application, that state continues to oversee the insurer through routine financial analyses. An important element of the financial analysis work is the review of annual and quarterly statements submitted by the insurance companies containing information, such as financial statements, responses to various questions about company activities, and various schedules summarizing investment and other business activity. NAIC assists the states' annual review efforts with numerous financial analysis tools, including the calculation of financial analysis ratios on insurance companies, known as the Insurance Regulatory Information System (IRIS) ratios.[4] These ratios, which are provided to the appropriate state regulators, help state insurance analysts identify areas of potential regulatory concern, particularly indicators that could suggest financial difficulties.

The states' on-site insurance examinations are intended to validate the insurers' financial condition and market conduct. According to NAIC's guidelines, examinations are to occur at least once every 5 years. One of the most fundamental tasks of the on-site examinations is to verify information the insurers have provided in regulatory reports. Because a company's solvency is determined by comparing the value of its assets and liabilities, a key regulatory concern is the existence and value of the insurer's reported assets.

[3] The state of domicile, or domiciliary state, is the primary regulator of an insurance company.

[4] Nearly all insurers, except for the smallest ones, submit their annual and quarterly regulatory reports to NAIC as well as to their domiciliary regulator. States where the companies are licensed also receive copies of the reports. NAIC then calculates a number of financial ratios, known as the IRIS ratios, performs some preliminary analyses, and returns the information to the domiciliary state. Ratios that are outside the "usual range" are flagged by NAIC for regulatory attention.

NAIC also issues guidance to assist regulators in performing financial analyses and examinations. For example, NAIC's *Financial Analysis Handbook* is designed to help states identify, as early as possible, insurance companies that may be financially troubled. It includes checklists on financial concepts and analyses deemed important to assess the company's financial condition. It is intended to serve as an advisory guide but is not an NAIC accreditation standard. The *Examiner's Handbook* is another tool developed by NAIC to assist state regulators in detecting as early as possible those insurers in financial trouble and/or engaging in unlawful and improper activities and to develop the information needed for timely, appropriate action. Both handbooks employ the use of checklists, but they also note or imply that state regulators must exercise sound judgement and assess the insurers in accordance with their own state laws and regulations.

Broker-Dealers Are Regulated by Federal and State Organizations

Within the securities industry, securities firms are regulated by the SEC, which delegates regulatory responsibilities to several self-regulatory organizations (SROs). The SROs for broker-dealers include the New York Stock Exchange and the National Association of Securities Dealers Regulation Inc. (NASDR). Additionally, state securities offices work in conjunction with SEC and the SROs to regulate securities firms. The functions of state securities offices include the licensing of some securities-related entities and agents. States also collect and monitor financial data of broker-dealers that they license in their states. The securities firm connected to the investment scam was a broker-dealer regulated by NASDR and licensed to conduct business in numerous states.

Congress Has Enacted Financial Services Modernization Legislation

Federal regulators, among others, have testified in recent years that constraints segregating various sectors of the financial marketplace have outlived their usefulness. Banks, securities firms, and insurance companies have increasingly offered a similar array of products and services. Moreover, these institutions have been merging. The technological advances and the development of new financial products and services has increasingly blurred the lines once separating the offerings of banks, securities firms, and insurance companies and thus also blurred the lines among regulators. The GLB Act's purpose was to establish a comprehensive framework to permit affiliations among commercial banks, securities firms, and insurance companies, allowing a "level playing field" while maintaining the safety and soundness of the financial system. It also recognized the need for greater regulatory consultation and coordination.

Scope and Methodology

To identify the nature of Mr. Frankel's alleged insurance investment scam, we obtained publicly available documents through the Department of Justice, including the federal indictment against Mr. Frankel. We also met with officials and conducted file reviews at SEC and NASDR to ascertain Mr. Frankel's past and recent activities in the securities industry. Within the insurance industry, we reviewed regulatory files and discussed the chronology of events with officials in states where the principal insurers connected to Mr. Frankel's alleged scam were domiciled—Tennessee, Mississippi, Missouri, Oklahoma, and Arkansas. We also visited officials in Virginia, where an insurer was negatively affected by a transaction with one of the Frankel-connected insurers. In addition, we conducted literature searches related to this investment scam.

To assess the regulatory oversight and information-sharing activities that occurred in connection with the Frankel matter, we visited the states identified above that were responsible for overseeing the insurers victimized by the scam and reviewed the pertinent regulatory files. Additionally, we reviewed the relevant policies and procedures in effect in those states during the years that Frankel apparently controlled the insurance companies. We also contacted officials in other states, including Alabama and Washington, to understand their dealings with insurance entities allegedly connected to Frankel. To ascertain the types of regulatory information available in the insurance and securities industries, we met with officials from NAIC, selected state securities offices, SEC, and NASDR and reviewed the appropriate records. We also discussed insurance regulators' access to criminal databases with Department of Justice officials.

To understand regulatory efforts to implement features of the financial services modernization legislation, the GLB Act, we met with regulatory officials in the insurance, banking, and securities industries who have worked closely on regulatory coordination issues. Specifically, we discussed the status of regulatory coordination efforts across industry sectors with officials at NAIC, the State of Connecticut's Insurance Department, the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and SEC.

The activities and events associated with Martin Frankel described in this report are alleged in the federal indictment. Federal and state authorities had criminal and civil cases pending against Mr. Frankel at the time of this report. Thus, additional facts relevant to regulatory activities are likely to be revealed as these cases proceed through the courts.

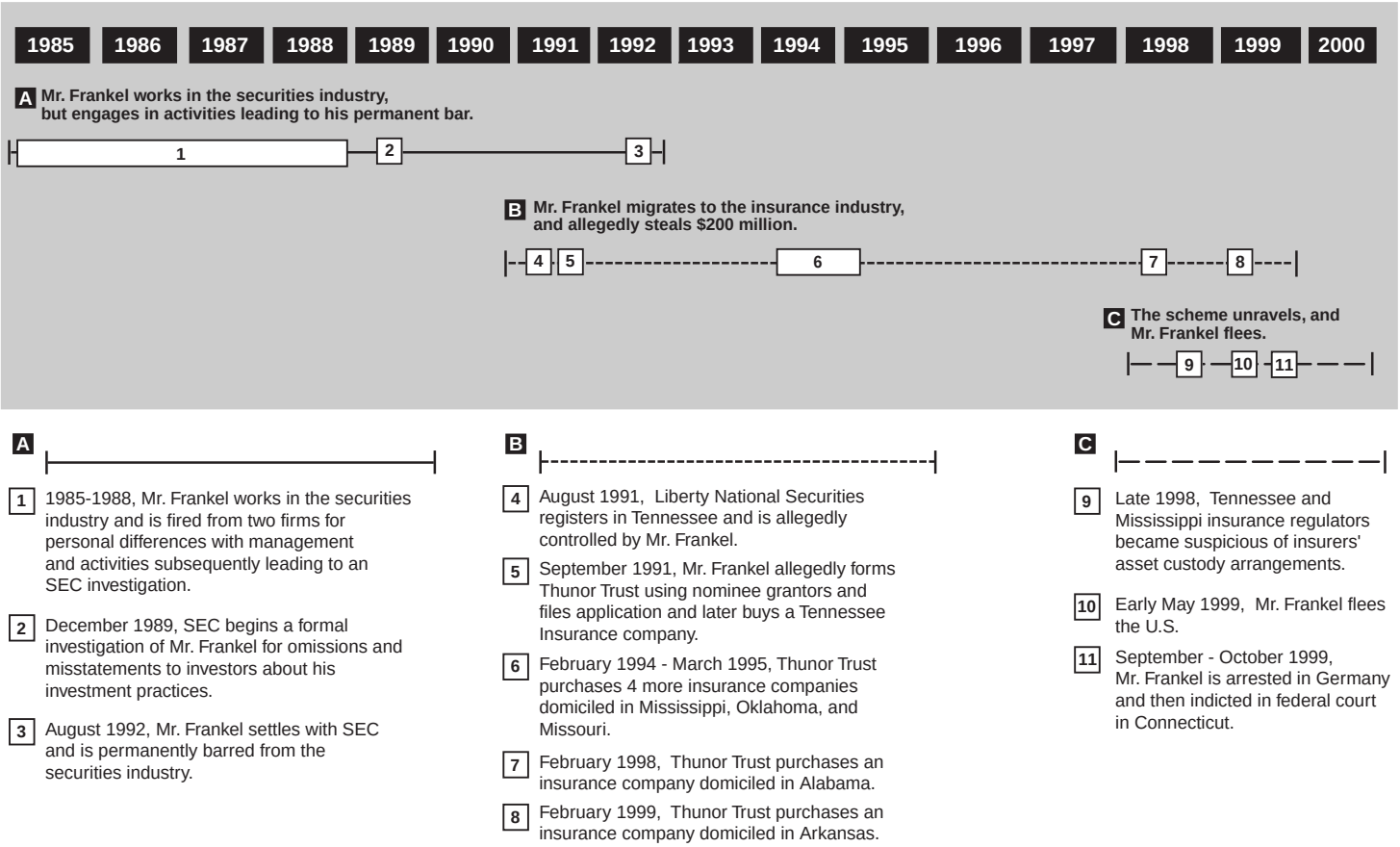
During our review, NAIC and state officials, with one exception, fully cooperated with our review, including granting us full access to records. In Mississippi, state officials did not provide us access to nonpublic records, such as workpapers associated with annual reviews and on-site exams, citing concerns over the release of such information because of ongoing litigation on the matter. During our review, we briefed some state officials and NAIC on our preliminary findings and observations to assist their efforts in developing corrective actions. The regulatory weaknesses we observed were not based upon an exhaustive analysis of all insurance regulatory procedures and practices, but rather on those most relevant to this particular scam.

We conducted our review in Nashville, TN; Jackson, MS; Jefferson City, MO; Oklahoma City, OK; Little Rock, AR; Richmond, VA; Montgomery, AL; New York, NY; Chicago, IL; Kansas City, MO; Hartford, CT; Bridgeport, CT; and Washington D.C., between October 1999 and August 2000 in accordance with generally accepted government auditing standards.

How Was the Alleged Scam Carried Out?

Throughout the 1990s, Martin Frankel allegedly gained secret control of entities in both the insurance and securities industries. While undergoing a disciplinary proceeding in the securities industry, Frankel allegedly migrated to the insurance industry. Working through others, he established a trust that was used to purchase insurance companies. Concurrently, he gained secret control of a broker-dealer that he used to disguise his diversion of insurance company assets. With the insurance and securities entities under his control, Frankel allegedly stole over $200 million belonging to the insurers before his scam unraveled. An overview of Frankel's alleged activities is depicted on a time line in Figure 1. His activities to gain control over entities in the insurance and securities industries and expand his investment scam are described in the sections below.

Figure 1: Overview of the Scandal



Source: GAO.

Frankel, a Rogue Broker, Allegedly Migrated to the Insurance Industry

In the early 1990s, Mr. Frankel is alleged to have gained control over entities in the insurance industry at the same time he was being investigated by SEC for misconduct in the securities industry. According to SEC officials, Frankel's activities as a rogue broker began in the mid 1980s when he made misstatements and misrepresentations to investors. In a 1991 civil complaint, SEC charged that Frankel raised over a million dollars through the offer and sale of limited partnerships in an investment fund he established. The complaint stated that Frankel had made omissions and misstatements about the use of proceeds from investors, his background and experience, and the performance of the fund he

controlled. In August 1992, Frankel consented to a permanent ban from the securities industry and agreed to return funds to the investors.

At the time he was being investigated by SEC, Frankel is alleged to have anonymously established Thunor Trust in 1991 and subsequently used it to purchase entities in the insurance industry. He is alleged to have anonymously formed this trust using the names of three acquaintances, identifying them as grantors to the trust. Another individual, who was named as the sole and irrevocable trustee, managed the trust.

Frankel allegedly used his anonymous control of Thunor Trust to purchase insurance companies. Shortly after it was formed in 1991, Thunor Trust acquired the majority interest in Franklin American Corporation, which, in turn, owned Franklin American Life Insurance Company, an insurer domiciled in Tennessee. Frankel allegedly continued to use Thunor Trust as a means to acquire other insurers with the assets of those that he had previously acquired.

Our review of the insurance regulatory files on the Thunor Trust group of insurers confirmed that Mr. Frankel's name did not appear on the change in ownership applications, which were documented on a Form A (previously described in the background section). Ownership of the insurers could be traced back to Thunor Trust, which, in turn, was managed by another individual who served as the sole, irrevocable trustee on behalf of the trust's beneficiaries. These beneficiaries were identified in the Form A documentation as relatives of the three grantors who ostensibly established Thunor Trust.

Concurrently, Frankel Allegedly Gained Control of a Broker-Dealer to Help Disguise the Scam

At the same time Mr. Frankel was allegedly acquiring the assets of insurance companies, he also controlled certain business activities of a small broker-dealer registered with securities regulators. Frankel then allegedly used the name of this broker-dealer when (1) taking custody of insurance company assets and (2) providing false documents concerning the insurers' investment activities. With the broker-dealer serving as a front for his investment scam, Frankel allegedly diverted insurance company assets unlawfully into accounts he controlled to support his lifestyle and perpetuate the scam.

Despite being barred from the securities industry in 1992, Frankel allegedly controlled a small brokerage firm named Liberty National Securities (LNS).[5] Frankel allegedly used LNS as a front, controlling LNS' business

[5] LNS, a small broker-dealer established in Ohio in 1991, moved to Michigan in 1993.

activities with assistance of an individual associated with the firm. According to information obtained from NASDR, Frankel paid this individual $2,000 per month to perform certain business functions in the securities industry.

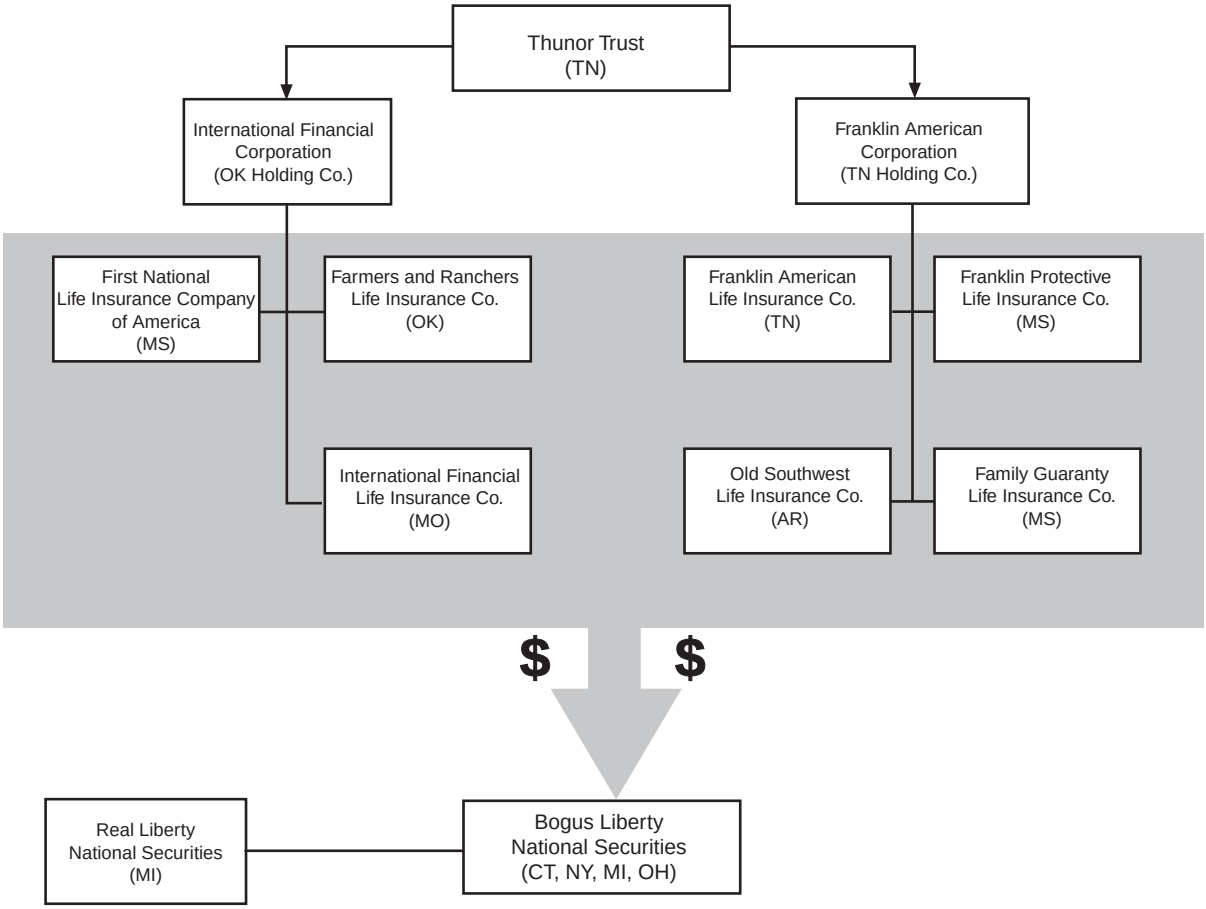
Borrowing the name of LNS, Frankel allegedly took custody of insurance company assets and provided false documents on investment activity to the insurance companies. Through his association with an individual from the real LNS, Frankel allegedly got the firm's name licensed in numerous states throughout the country, including those where he had insurance companies under his control. In addition, telephone calls and mail were forwarded through LNS, located in Dundee, MI, to Frankel's mansion in Connecticut. Authorities charge that Frankel operated the scam from this residence. Instead of investing the assets in a prudent manner, Frankel allegedly diverted the insurer assets to other accounts he controlled.

Our review of information available at SEC and NASDR revealed that LNS was a small broker-dealer located in Toledo, OH, with less than $10,000 in assets when it was formed in 1991. In April 1993, the firm moved to Dundee, MI. Mr. Frankel's name did not appear on the filings LNS made with SEC and NASDR. Regulatory data from state securities offices and NASDR revealed that before the collapse of the scam in 1999, LNS had approximately $60,000 in assets and was licensed to conduct business in numerous states throughout the country, including those where Mr. Frankel allegedly controlled insurers' assets. In addition, records at SEC revealed numerous investment accounts under Mr. Frankel's direct control at other brokerage firms.

Frankel Allegedly Expanded His Scam from 1991-1999 and Stole Over $200 Million

With entities in the insurance and securities industry under his control, Frankel allegedly expanded his investment scam throughout the 1990s, stealing over $200 million of insurer assets. Assets belonging to the insurers held by Thunor Trust were ostensibly invested with LNS and systematically funneled by Frankel into other accounts he controlled. Mr. Frankel allegedly continued a pattern of purchasing insurance companies using money from previously acquired insurers. By 1999, the Thunor Trust group of insurers included seven insurance companies, one domiciled in Tennessee; three in Mississippi; and one each in Missouri, Oklahoma, and Arkansas. A simplified organizational chart of the entities connected to the investment scam is shown in figure 2.

Figure 2: Simplified Structure of the Thurnor Trust Insurance Companies



Source: GAO summary of insurance regulatory data.

To portray his investment operation as legitimate, Frankel allegedly fabricated phony account statements that seemingly reflected positive results on investment activities of the insurers' assets that LNS was managing. These account statements typically reported a relatively high level of trading volume on the insurers' assets, often indicating that significant portions of the companies' assets were being traded on almost a daily basis. Furthermore, the LNS account statements generally reported above market returns on the trading activity of U.S. government securities. The insurers subsequently used figures from these allegedly phony statements in their required annual filings with regulators, attesting to the financial health and business activities of the insurance companies. Allegedly, the assets were not traded and invested as reported in the LNS

statements. Instead, they were diverted into other accounts controlled by Frankel, who used the funds to perpetuate the investment scam and support his lifestyle.

Frankel continued to expand the asset portfolio under his control through reinsurance agreements, particularly in the later years of the scam.[6] Under these agreements, insurers under Thunor Trust purchased books of business from other insurers and assumed the assets and liabilities from the other insurers. Through these reinsurance agreements, Frankel allegedly obtained control over significant assets from other insurers outside those under Thunor Trust. One such insurer was Settlers Life, domiciled in Virginia. The company lost about $45 million through a reinsurance transaction with one of the Thunor Trust insurers in April 1999.

After operating for nearly 8 years, the investment scam began to unravel as insurance regulators placed more scrutiny on the insurers' asset custody arrangements with LNS. Eventually, the Thunor Trust insurers domiciled in Tennessee and Mississippi were ordered by their respective state insurance departments to remove their assets from the custody of LNS. In April 1999, through the enforcement of a law fashioned after a model law recommended by NAIC to safeguard insurer's assets, the Tennessee Department of Commerce and Insurance was able to safeguard the assets belonging to the insurer domiciled in its state, which were ultimately placed into a state of Tennessee account in May 1999. On April 29, 1999, the Mississippi Insurance Department decided to place three of the Thunor Trust insurers domiciled in that state under Administrative Supervision because of concerns related to LNS and the possibility that Thunor Trust might have been taken over by another organization, the Saint Francis of Assisi Foundation, without prior approval. Prior to the collapse of his investment scam, Frankel had allegedly attempted to purchase other insurers through this foundation.

During the first week in May 1999, the sole trustee of Thunor Trust and its affiliated insurance companies announced that the assets of the insurers were gone. Insurance regulators in Missouri, Oklahoma, Arkansas, and Virginia said they were informed of the investment scam involving companies domiciled in their states shortly thereafter. In the aftermath, federal authorities alleged that Frankel stole the insurers' assets.

[6] In reinsurance transactions, generally the insurer that purchases a book of business assumes the assets and liabilities associated with the policies of that business in exchange for the purchase price.

Victims of the Scandal Include Taxpayers and Policyholders

Federal and state authorities now have criminal and civil cases pending against Frankel and others allegedly connected to the scam. In addition to the criminal indictment information previously described, several states have now joined in civil suits against Frankel, his associates, an accounting firm that audited the Thunor Trust insurers, and legal professionals. Some associates of Frankel have pled guilty on certain offenses to federal authorities for their roles in the scam, and federal and state criminal investigations and efforts to recover funds from those who perpetrated the scam are ongoing. Appendix II summarizes key events associated with the investment scam.

Taxpayers and certain policyholders in some states will bear much of the financial burden resulting from the scam unless federal and state authorities successfully recover significant funds from those who perpetrated it. According to the National Organization of Life and Health Insurance Guarantee Associations (NOLHGA), the initial estimated costs to state guarantee associations is approximately $133 million on covered obligations of approximately $190 million.[7] Other indirect costs include additional legal and regulatory costs incurred by state and federal officials emanating from the scandal. Although state guarantee funds help protect policyholders in cases where insurers become insolvent, a portion of such losses is ultimately borne by the public at large, because insurers domiciled in some states are eligible to offset a portion of the amounts assessed by the states' guarantee funds against premium taxes collected by these states. Numerous policyholders have also been victimized by the scandal through shortfalls in coverage from certain state guarantee fund programs. For example, according to the liquidator for First National Life Insurance Company of America (one of the Frankel-controlled insurers), about 3,000 policyholders and annuitants of the insurer who are California residents are backed for only 80 percent of the value of their policies through the state's insurance guarantee program. This insurer also sold policies with annuity riders on U.S. military installations overseas, and some policyholders who are not U.S. citizens are not covered by any state guarantee association program.

[7] After an insurance company becomes insolvent, policyholders are protected to varying degrees by their own state's insurance guarantee program. Therefore, one insurance company failure can trigger the need for coverage from numerous state insurance guarantee programs to the extent that policyholders of the failed insurer are residents of different states. Coverage under each state's insurance guarantee program is limited, and the limits vary by state. According to NOLHGA, over 90 percent of policyholders have been fully protected from insurer insolvencies since 1992, when the last guarantee associations were established.

Numerous Regulatory Oversight Weaknesses Contributed to Delays in Detection

Weaknesses associated with insurance regulatory tools and inadequate oversight and coordination activities contributed to delays in detecting the investment scam for years. Regulatory weaknesses were observed in the domiciliary states' oversight activities as well as with certain support services provided by NAIC. As shown in table 1 below, we identified weaknesses in the three key phases of regulatory oversight—change of ownership approval, routine financial analyses, and on-site examinations. We observed repeated instances of inadequate tools, policies, procedures, and practices as well as a lack of information-sharing among different regulators, within and outside the insurance industry. Many of the specific events and circumstances that we found were not necessarily inconsistent with laws or regulations; however, they were sufficiently unusual that either individually or collectively, they provided reasonable grounds for regulators to have asked additional questions beyond those routinely addressed. The answers or, in some cases, the lack of answers, to those questions could have resulted in a much earlier exposure of the scam. Unfortunately, these questions were not sufficiently pursued and resolved in a timely manner. Insurance regulators, working through NAIC, have recognized the regulatory weaknesses we identified and have begun addressing or intend to address them with corrective actions to help reduce the industry's vulnerability to fraud.

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.

Regulatory Weaknesses Observed During Change In Ownership Approvals

Regulatory weaknesses observed during change in ownership approval activities included inadequate (1) due diligence of buyer application data, (2) tools and procedures for verifying applicants' backgrounds, and (3) regulatory information-sharing both within and outside the insurance industry. The states' review of the data associated with an application for the change in ownership of an insurance company, documented in a format prescribed by NAIC known as a Form A, did not include checks on individuals' regulatory or possible criminal histories. Furthermore, regulators often did not appear to question unusual aspects of the purchase of an insurer under Thunor Trust. Additionally, insurance regulators did not effectively share information on the status of Form A applications among states nor did they seek regulatory data on applicants from other financial services industries.

Inadequate Due Diligence Performed on Buyer Application Data

The purchase of insurance companies under Thunor Trust provided a number of opportunities for regulators to ask questions about the prospective owners. We believe some of these questions should have been routine--part of the normal process of approving a regulated insurer's change in ownership control. Other questions could have been raised by the unusual characteristics of the trust or of the change in ownership. Had regulators exercised a higher degree of scrutiny or professional skepticism during these purchases, the scam may have been detected earlier.

Routine questioning during the change in ownership approval process includes determining the intentions and appropriateness of the buyer; that is, those who are providing the money for the purchase. In the case of Thunor Trust, the money to purchase the first insurance company was supposedly provided by three individuals or grantors. However, during our review of change in ownership application data, we found no evidence that state regulators sought financial information from the grantors to validate their financial condition despite the trust's dependence on the grantors for funds. Moreover, we found no evidence that any state regulators ever directly questioned the Thunor Trust grantors to validate their ownership interests, business intentions, and control of the trust in spite of a number of unusual characteristics associated with the change in ownership applications.

Unusual conditions or red flags present on the change in ownership applications associated with Thunor Trust centered on the trust arrangement itself. A review of the documentation on the trust revealed that the three grantors who supposedly provided $3.75 million to establish the trust in 1991 had no control over their money. In assessing the ultimate controlling interests behind an insurance company, one would

expect to see a connection between the firm's control and the individual(s) who provided the money to purchase it. Instead, the trust was established in a manner that left one individual, who was not a grantor to the trust, in complete control of the trust and whose authority to manage the trust was irrevocable, even by the grantors of the trust. The trustee was supposed to manage the assets of the trust on behalf of the trust's beneficiaries, who were family members of the grantors. However, the trust agreement did not give the purported grantors any authority to remove the sole trustee on the basis of how that individual managed the trust, thus leaving the grantors with no control over their money.

The Thunor Trust entity apparently deceived regulators about who the actual ultimate controlling interests were behind the trust and, in turn, the interests behind the insurance companies purchased under the trust. The trust arrangement that appeared to leave those who established the trust with no mechanism of control in how the trust operated provided red flags that could have raised questions for regulators. The federal indictment now alleges that Frankel himself established the trust using the names of three acquaintances who never actually contributed funds to the trust. 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 in the trust, as the money was being used to purchase insurance companies, the scam could have been uncovered during the Form A application process.

Inadequate Tools and Procedures to Validate Individuals' Regulatory or Criminal Backgrounds

Tools and procedures used by insurance regulators were not adequate to verify applicants' regulatory histories or potential criminal backgrounds. During our visits to the states and review of the applications associated with the insurer acquisitions under Thunor Trust, we found that states could not readily validate an individual's background in other financial services industries. Furthermore, in contrast to bank and securities regulators, state insurance regulators generally cannot verify self-reported information provided by individuals in response to questions about their criminal history. According to NAIC, most states lack the regulatory authority to obtain criminal history data for noncriminal purposes.

During this investment scam, a check into the regulatory history of the grantors of Thunor Trust would have revealed unfavorable incidents with one of the grantors in the securities industry. These incidents, which were not necessarily of a nature to preclude the individual from owning an insurance company could, however, have prompted additional regulatory scrutiny on the grantor's intentions in the insurance industry. Because Frankel is alleged to have formed the trust without the money of the

supposed grantors, questioning these individuals directly about their regulatory histories and interest in the trust could have unraveled the scam at the outset.

NAIC officials acknowledged that there is not currently an expectation in NAIC's guidance for the states to perform regulatory and criminal background checks on the self-reported information provided in Form A applications. There are limitations to insurance regulators' access to regulatory and criminal history data from other government agencies. Insurance regulators cannot readily access disciplinary-related information generated on individuals in the banking or securities industry, other than through publicly available means. Additionally, insurance regulators generally cannot routinely validate whether or not an individual has a criminal background in spite of a federal insurance fraud prevention provision that prohibits individuals with a felony criminal history involving fraud or breach of trust from entering the insurance industry without the consent of insurance regulators.[8] Insurance regulators maintain that they cannot verify an individual's potential criminal background because most state insurance departments do not have access to criminal history data. Background data on key individuals associated with the purchase of an insurer are obtained in the Form A application through self-reported data on a Biographical Affidavit. This affidavit asks, among other things, if an individual has ever been charged with any wrongdoing by any governmental authority or been charged or convicted of a crime.

Although other financial services regulators have established mechanisms that allow them to routinely conduct criminal history checks through the Federal Bureau of Investigation (FBI), state insurance regulators and the Department of Justice have not yet implemented a similar mechanism for insurance regulators. Officials from several banking regulatory agencies explained that as part of their due diligence processes on charter applications, they submit information on key officials associated with the applications to the FBI for the purpose of conducting criminal background checks. An FBI representative confirmed that banking and securities regulators conduct background checks by submitting information on individuals to the FBI. The representative mentioned that insurance regulators could obtain criminal history data in such a manner, provided they had the statutory authority to do so. Another Justice official concurred that most insurance regulators do not currently have access to

[8] 18 U.S.C. § 1033 provides that, among other things, a person who has been convicted of any criminal felony involving dishonesty or a breach of trust or any offense described in the section may engage in the business of insurance only through the written consent of an insurance regulatory official authorized to regulate the insurer.

criminal history data, given their lack of law enforcement status. This official believed that current legislation may give insurance regulators the right to such criminal history data for noncriminal justice purposes, although implementation of such authority has yet to be accomplished and may require an Executive Order. Justice officials stated that procedural matters need to be worked out between the FBI and the insurance industry.

Lack of Coordination Among Regulators Within and Outside the Insurance Industry

Although insurance regulators lacked the tools to directly access regulatory history information from other financial sectors, we were able to access such information from other available sources. As previously mentioned, NAIC officials acknowledged that state insurance regulators are not expected to validate regulatory or criminal background data provided by applicants on Form A filings. However, concerning the purchases of insurers under Thunor Trust, regulatory data available to insurance regulators from state securities departments could have raised concerns over the regulatory history of an individual supposedly providing the money to purchase the insurance companies. Additionally, lack of regulatory coordination within the insurance industry hindered detection of the investment scam.

During visits we made to the states, we were able to access regulatory history data available from state securities regulators through a database known as the Central Registration Depository (CRD).[9] As previously mentioned, information from CRD revealed that an individual whose name appeared in the Form A applications as a grantor to Thunor Trust was involved in incidents concerning consumer complaints while working in the securities industry. Although the incidents identified through CRD varied in their degree of severity, they could have prompted insurance regulators to question the grantors directly concerning their previous activities in the securities industry and the nature of their business interests in the trust and insurance industry. Because the grantors may have been unaware of the trust and deny having provided any funds, this level of due diligence may have caused regulators to refuse approval for Thunor Trust's purchase of insurance companies.

Other information-sharing issues that surfaced during the change in ownership approval oversight phase involved the lack of information-sharing about regulatory concerns and actions among insurance regulators

[9] CRD is a database maintained by NASD and used by state securities regulators, SROs, and SEC that contains information on broker-dealers, including incidents of disciplinary items tied to individuals and firms.

in different states. For example, regulators in Arkansas considered and approved a Form A application involving the purchase of Old Southwest Life Insurance Company under the Thunor Trust organization. Prior to this approval, another Form A application was submitted and withdrawn in Colorado by the Saint Francis of Assisi Foundation, an entity that had been identified as being affiliated with the insurers under Thunor Trust. Arkansas insurance officials indicated they would have been better able to scrutinize the Form A application submitted on Old Southwest had they known an entity linked to Thunor Trust, the Saint Francis of Assisi Foundation, had withdrawn a Form A application in Colorado. However, no such clearinghouse of Form A information exists. Regulatory officials pointed out that the withdrawal of a Form A application itself would "raise a red flag." On the basis of this experience, the Insurance Commissioner in Arkansas recommended that NAIC consider creating a resource for regulators to review other relevant From A application information from other states.

Another information-sharing issue surfaced during the redomestication of an insurer.[10] When an insurer under Thunor Trust was redomesticating from Alabama to Mississippi, examiners in Mississippi already had concerns about the possibility that a broker-dealer, LNS, was affiliated with two other Thunor Trust insurance companies already domiciled in Mississippi. However, we found no evidence that Mississippi Insurance Department officials approving the redomestication of the company from Alabama knew of these concerns.

The purchase of Old Southwest Life Insurance Company also exhibits another example of inadequate information-sharing among state regulators. Prior to this purchase 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. 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 under Thunor Trust may have been looted of its assets, they could have had an opportunity to ask additional questions and warn their domiciled

[10] Redomestication of an insurer refers to the insurer's action to change its state of domicile.

insurers against entering into transactions with an insurer(s) connected to Thunor Trust without prior regulatory approval.

An exception to instances of inadequate information-sharing between insurance regulators during change in ownership approval activities occurred shortly before the scam collapsed; it involved the coordination efforts between regulators in Mississippi and the state of Washington. Regulators in Washington State had been urged by the proposed buyers to proceed in an expedited fashion with their planned purchase of an insurer domiciled in that state. The proposed buyer was the Saint Francis of Assisi Foundation, now reported to have been an entity that Frankel created to further enhance the appearance of legitimacy in purchasing and controlling the insurance companies. In contacts initiated by regulators in Washington State, Mississippi insurance officials warned their counterparts to proceed cautiously with the approval of the proposed purchase. Mississippi regulators had encountered the name of Saint Francis of Assisi Foundation in connection with their ongoing examination of two insurers and became concerned that the Foundation may have obtained control of Thunor Trust without prior regulatory approval. Heeding the warnings from their Mississippi counterparts, regulators in Washington State continued to scrutinize the legitimacy of the Saint Francis of Assisi Foundation. The investment scandal unfolded before a formal Form A application was ever submitted.

Regulatory Weaknesses Observed During Routine Financial Analyses

Regulatory weaknesses we observed during routine financial analyses performed on the Thunor Trust insurers included inadequate asset investment analysis activities, ineffective safeguards and procedures to monitor and verify control of the assets, and virtually no efforts to seek securities-related information on the broker-dealer from other financial regulators. Controls pertaining to asset safeguards and investment activities are key solvency considerations. Regulatory weaknesses in these areas were observed in multiple states over several years.

Inadequate Analysis of Securities Investments

Insurance regulators and NAIC did not have procedures or expertise to assess the viability of the securities trading activities reported by the Thunor Trust insurers. State insurance regulators and NAIC received annual statements from the Thunor Trust insurers that clearly showed the unique investment activities of the insurers. These activities were characterized by an unusually high level of trading and turnover of the insurers' assets, which primarily consisted of government bonds. Generally, our review of available documents covering several years and related analyses by insurance regulators and NAIC found virtually no

concerns about asset investment practices until the later stages of the investment scam.

During our review, we found little evidence that state insurance department financial analysis staff had concerns about the massive asset trading activity being reported by the Thunor Trust insurers. Only in Tennessee did we observe isolated instances of concerns by regulatory staff but not sufficient to generate timely follow-up and resolution of such concerns. Routine financial analysis reviews conducted in accordance with NAIC's guidelines on the Thunor Trust insurers in Oklahoma, Missouri, and Mississippi also did not trigger additional scrutiny.

Our review showed that NAIC's activities and guidance to support the states' routine financial review efforts did not address asset turnover.[11] Specifically, the ratio analyses that are generated for insurance companies did not include an asset turnover ratio. For example, NAIC's policies and procedures in the *Financial Analysis Handbook*, used by state insurance regulators to conduct routine financial analyses on insurers, did not reveal any specific analysis requirement related to asset turnover nor a threshold test that would trigger additional regulatory scrutiny of this type of investment activity. Additionally, the analyst worksheets associated with routine reviews on the Thunor Trust insurers did not disclose evidence of concerns over the massive trading activity being reported or the consistently greater-than-normal government bond trading returns. We also noted that these year-end company numbers were subject to independent Certified Public Accountant (CPA) audits each year, and the reports were furnished to regulators and NAIC. Our review of available audit reports, company management and discussion analysis documents, and NAIC synopses contained in NAIC files did not reveal any skepticism about the trading activity. Because of ongoing investigations and civil cases, we could not assess the adequacy of the financial statement audits conducted by a CPA firm on the Thunor Trust insurers.

From the company filings made with NAIC and concurrently with the state insurance departments, we performed a simple financial ratio test

[11] NAIC aids the states' efforts to perform annual financial reviews on companies through the generation of the IRIS ratios and an Analyst Team that performs an additional financial review on certain companies on the basis of the IRIS ratio results. The process for generating the IRIS ratios includes obtaining insurers' annual statements, entering the reported financial data into a computer system, performing cross-checks on the data to check for errors, and calculating 12 different financial ratios (for life and health insurers) to help identify companies that could experience financial difficulties. Once these ratios are calculated, an Analyst Team conducts a further review of insurers whose IRIS results exceeded certain unusual thresholds. This team then recommends to the states the regulatory attention required by the insurers to help the regulators prioritize their workload.

structured to flag highly speculative trading activity—also referred to as an asset turnover test. This analysis, highlighting the unusually high asset turnover activity, is presented in table 2 below.[12]

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 company's assets weekly. By contrast, a mutual fund expert recently cited concern about equity fund managers whose asset turnovers now average about 0.9.[13]

In April 2000, NAIC officials advised us that new ratio tests to flag possible speculative asset investment activities have 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. NAIC officials also reported they have revised the *Financial Analysis Handbook* instructions in this area.

Ineffective Mechanisms to Safeguard and Monitor Control of Insurers' Securities Held By Another Entity

Throughout the 1990s, regulators were unable to properly safeguard and monitor the assets of the Thunor Trust insurers. The regulators' inability to effectively safeguard and monitor control of insurers' assets centered on the varied and ineffective policies regarding asset custodial arrangements. In some instances, regulators discovered there was no custody agreement between the insurer and LNS. In other cases, the custody agreement did not provide sufficient measures to safeguard or recover insurers' assets.

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

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

In addition, regulators did not seek sufficient information to verify the legitimacy of new custodians. Lastly, the annual statement information obtained from insurers was inadequate to monitor who had control of the insurers' assets.

One key regulatory tool that could have helped regulators hinder the investment scam at different points in the oversight process was a model law developed by NAIC to help safeguard insurers' assets. This model law, NAIC Model Law No. 295, together with its accompanying model regulation, NAIC Model Regulation No. 298, requires that only national banks, state banks, or trust companies be used as custodians for securities belonging to insurers.[14] Furthermore, the model regulation includes forms that can be used for the purposes of preparing custody agreements. However, NAIC, in its accreditation program, does not require states to adopt or follow this model law and regulation. We found that asset custodial requirements prescribed by this model law and regulation were not followed in Missouri, Mississippi, and Oklahoma on the Thunor Trust insurers domiciled in those states. Another state, Tennessee, adopted the custody agreement prescribed in the model regulation, but it failed to properly enforce insurer compliance with the custody agreement throughout most of the 1990s by allowing the insurer to execute the agreement with a broker-dealer, contrary to NAIC's guidance and Tennessee's insurance regulations.[15] Proper enforcement of such requirements on a regular basis could have helped prevent the scam, because this would have prohibited a broker-dealer from maintaining custody over the insurers' assets. Additional information on NAIC's Model Law No. 295 and Model Regulation No. 298 is discussed in Appendix III.

The procedures and practices to monitor control of the insurers' assets were also inadequate, because they did not always convey a clear understanding of who controlled these assets. Insurance regulators monitor the financial condition of insurers through the analysis of annual and quarterly statements that are prepared in accordance with NAIC guidelines and instructions. The General Interrogatories section of the annual statements addressed the issue of which entity(ies) had control and custody of the insurer's assets. One of the questions in this section essentially asked the insurers if they had physical custody of their assets at

[14] NAIC's Model Law 295 and the accompanying Model Regulation 298 outline the asset custody requirements recommended for assets traded through clearing corporations using the Federal Reserve book-entry system. Book-entry refers to a method of settlement in which no physical delivery of the item bought or sold is made, but the change in ownership is recorded by the custodian, normally on a computer system.

[15] Tennessee *Rules of Department of Insurance*, Chapter 0780-1-46.

year-end.[16] A "yes" response would indicate that the insurer had custody of its assets, whereas a "no" response would prompt the insurer to describe further details concerning who had custody of its assets. On quarterly updates of the financial statements, the General Interrogatories did not specifically address the issue of physical custody of the assets.

We found no evidence that state regulators had carefully scrutinized information in the annual statements that highlighted the asset custody situation until the later stages of the investment scam. Our review of the annual statements between 1991 and 1998 revealed incomplete and inconsistent reporting by the Thunor Trust insurance companies. For example, in 14 of the 28 statements submitted during the 1990s in which the insurer acknowledged it did not have physical possession of its assets, the insurer did not provide sufficient information as to who did control its assets. Specifically, the instructions for this annual statement question state "If no, give full and complete information relating thereto." However, the instructions do not indicate the types of information needed in the case of a "no" response. In such cases, the Thunor Trust insurers typically responded that the assets were "HELD BY BROKER IN STREET NAME." Such a response did not provide regulators with sufficient information to determine the entity(ies) that had control of the insurers' assets. In these instances, regulators needed to pursue additional questions and research into the matter to determine who did have control of the assets. Moreover, we found instances in Tennessee, Missouri, and Oklahoma where the analysts' review of the annual statements did not flag the "no" response for further supervisory review.

We also observed that inconsistent information reported by the insurers was not detected due to the lack of procedures and practices to verify the self-reported data. In instances where the insurer responded affirmatively that it had physical custody of its assets, we did not find evidence that regulators attempted to validate the insurer's response. We noted on several occasions that such a response was inconsistent with other regulatory information available on the insurer. For instance, in Tennessee, Missouri, and Oklahoma, insurance companies sometimes reported in annual statements that they had control of their assets despite other information from annual reports and examinations that suggested their assets were in the custody of a broker-dealer.

[16]In annual statements filed by the Thunor Trust group of insurers for years ending 1991 through 1998, in accordance with the format prescribed by NAIC, a question related to asset control reads "Were all the stocks, bonds and other securities owned December 31 of the current year, over which the company has exclusive control, in the actual possession of the company on the said date, except as shown by the Schedule of Special Deposits?"

Responses to the asset custody-related question in the annual statement could have been compared for consistency with other regulatory records related to the custody of the insurer's assets as well as with financial statements of other Thunor Trust insurers. Regulatory records associated with asset control include custodial agreement(s) between the insurer and the entity(ies) with possession of the insurer's assets as well as those used by the independent CPA firm to verify asset balances with other financial institutions annually. However, NAIC's *Financial Analysis Handbook* guidance does not address the steps regulators could take to verify insurers' responses about the custody of their assets. Rather, NAIC officials indicated that such asset verification steps would occur during on-site examinations. Because on-site examinations generally occur only once every 3 to 5 years, an improper response on the annual statements related to who was maintaining custody of the insurer's assets may not be detected in a timely fashion. Furthermore, because annual financial reviews were not conducted on a consolidated basis to assess the financial statement information across all the insurers of the same group, regulators could not easily identify inconsistencies in responses related to asset control among the Thunor Trust insurers.

There are other more general problems with the asset custody information collected by regulators. For instance, the question in the General Interrogatories of the annual statements addresses only asset control on December 31st. Additionally, the question could be confusing in cases where assets are maintained in book-entry form with the Federal Reserve, because the question refers to the physical custody of securities. Although instructions to this general interrogatory have been revised over time to clarify its meaning, the responses to the question still did not clearly convey a meaningful understanding of the entity(ies) that may have controlled the insurers' assets throughout the year.

Inadequate Securities-Related Expertise and Information-Gathering

When questions concerning an insurer's investment activities did arise, financial analysts did not generally seek regulatory data or expertise from regulators in the securities industry. A check of basic information on LNS at any point throughout the 1990s with state securities offices could have helped unravel the investment scam. However, during our review, we did not find evidence that state insurance analysts obtained information from state securities offices while conducting their annual reviews because the NAIC guidelines do not specifically require such coordination. During our review, we collected information from several state securities offices on the real LNS that revealed inconsistencies with the information on the LNS entity that insurance regulators had been provided by their domiciled insurers. As mentioned earlier, Frankel allegedly used the real LNS as a

front, getting the firm's name licensed in states where he intended to perpetrate his scam. 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 would have been 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. The real LNS was a firm that started out in Toledo, OH and moved to Dundee, MI. However, the account statements that insurers were receiving from LNS indicated that the firm had locations in multiple states, including a New York, NY address. 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. Also, 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.

Although some insurance regulators acknowledged the insurers' investment activities were unusual, they did not seek such outside securities expertise. For instance, in Tennessee, analysts were sent to Franklin American Life in 1996 to review the company's unusual investment activities. According to the Tennessee Comptroller of the Treasury's report, the Insurance Division was concerned that the company might be "short selling" its assets, a risky and prohibited type of trading activity involving the sale of investments instruments without ownership in anticipation of a fall in prices.[17] However, the analysts involved in the targeted review acknowledged that they did not have a background in securities for adequately assessing the reasonableness of the insurer's high volume of trading. After a 1-day target review to assess the company's investment practices, which revealed no indication that the company was "short selling," analysts recommended that a securities expert be brought in to review the insurers' investment practices further. However, rather than seeking such expertise externally or from their local state securities office, the Tennessee Department of Commerce and Insurance did not

[17] Special Report: Review of Inaction on the Part of Insurance Division Employee's Involved in the Regulation of Franklin American Life Insurance Company, Tennessee Comptroller of the Treasury (Jul. 7, 2000).

conduct a meaningful review into the issue until an on-site examination was conducted approximately 2 years later.

Regulatory Weaknesses Observed During On-Site Examinations

The regulatory weaknesses observed from our review of the states' on-site examinations included the failure to detect the misappropriation of assets, inadequate procedures and practices to verify the legitimacy of the custodian, and inadequate information-sharing of examination concerns to prevent the scam from spreading further. Such weaknesses resulted in missed opportunities for regulators to uncover the scam earlier. Examinations conducted in the early and mid-1990s did not reveal the investment scam, even though assets had already been removed from the control of the insurers. Finally, during examinations conducted in 1998 through 1999, examiners in Mississippi and Tennessee began to scrutinize the LNS entity itself, and the investment scam began to unravel. Unfortunately, the lack of proactive information-sharing among regulators resulted in additional losses as the scam spread further before it was fully revealed in May 1999.

Failure to Detect Misappropriation of Assets

We found that four completed examinations on the Thunor Trust insurers did not uncover any material weaknesses even though Frankel allegedly embezzled the insurers' assets shortly after their purchase, prior to the examinations. One key reason that examiners were not aware that the insurers did not have control over their assets related to NAIC's examination procedures for verifying securities-related assets. These procedures require the insurance examiner to verify the insurers' securities by actual inspection and count unless these securities are being held under a custodial arrangement by a depository institution, such as a bank, trust, or securities depository.[18] However, examiners could not physically inspect the book-entry government securities because records of such transactions are maintained through computers, and no physical possession of the securities takes place. Consequently, examiners accepted listings from the broker-dealer to satisfy asset verification tasks on numerous occasions as if the entity were a bank or trust custodian, contrary to procedures in NAIC's *Examiners Handbook*.

Although adherence to NAIC's model law and regulation on suitable asset custodians is not currently a requirement of NAIC's accreditation program, adherence to the *Examiners Handbook* is. As mentioned earlier, NAIC's Model Law No. 295 and Model Regulation No. 298 recommend that only

[18] NAIC's examination guidelines explains that acceptable securities depositories are those that are subject to the regulation of SEC, the Federal Reserve System, and state banking authorities in the state of domicile. According to NAIC, broker-dealers are not securities depositories.

banks and trust companies, including subsidiary trust companies of brokerage firms, be used as custodians for insurer assets. The *Examiners Handbook*, which state insurance examiners follow to conduct on-site examinations of insurers, contains procedures to verify assets that build upon the premise that only these types of depository institutions be used as asset custodians.[19] If these kinds of institutions hold insurers' assets, asset verification procedures can be satisfied through a certified listing of the insurers' securities provided by the custodian. Otherwise, the securities belonging to the insurers are supposed to be verified through physical inspection and count.

The examination procedures applicable during the examinations completed on the Thunor Trust insurers did not specifically include measures for verifying book-entry securities being held by a broker-dealer. Although the examination procedures require examiners to physically inspect and count the securities that are not held by a bank, trust company, or securities depository, the assets were book-entry government securities that could not be physically inspected. As a result, the existing examination procedures did not address how to perform independent asset verifications under these circumstances.

To verify insurers' assets, state regulators requested that the broker-dealer identify what securities it held on behalf of the insurer and the associated value of these securities. In turn, an "authorized representative" of LNS sent back the document, in the form of an unnotarized letter or account balance type of form, affirming that such securities belonging to the insurer existed. After the scam collapsed, it was apparent that LNS and the insurers were, in fact, affiliated institutions, allegedly being controlled by Frankel. Therefore, the examinations completed on several Thunor Trust insurers never achieved an independent check on the assets and failed to detect the misappropriation of assets.

Additionally, as was the case in the annual financial analyses, the unusual investment activities being pursued by the Thunor Trust insurers could have prompted further regulatory action during the on-site examinations. Although the *Examiner's Handbook* does not specifically instruct regulators to assess the turnover of the insurer's assets, the practice of

[19] Two portions of this handbook in force when examinations were conducted on the Thunor Trust insurers relate to the assessment of asset custody arrangements and procedures to verify insurer assets. The first of such guidance in Part 1 of the *Examiners Handbook* contains specific narrative guidance on acceptable asset verification procedures and custody requirements. Part 2 of the *Examiner's Handbook*, titled "Specific Risk Analysis," contains a section on "Investments Cycle." This section in Part 2 describes the specific step-by-step procedures to verify insurers' assets that mirror the general narrative guidance described in Part 1.

investing virtually all of the firm's assets with one broker-dealer and constantly turning over these assets could have prompted more queries into LNS, including an assessment of the possibility that the insurers under Thunor Trust and LNS were related parties. Such inaction in response to these red flags raises questions about the level of expertise present in insurance departments to assess investment strategies being reported and pursued by the insurers. We did not find evidence that such an issue was substantively addressed during examinations completed in the mid 1990s on insurers in Tennessee, Missouri, and Oklahoma. Only in late 1998 and early 1999 did examiners in Tennessee and Mississippi begin to question the relationship between the insurers and LNS. When regulators finally began to scrutinize the investment activities and legitimacy of LNS, the investment scam began to unravel.

Inadequate Practices and Procedures to Verify the Legitimacy of Asset Custodians

Examination procedures used by insurance regulators were also inadequate to assess the legitimacy of the custodial entity or its authorized representatives. The examiners accepted custodial agreements and asset verifications for LNS that were supposedly signed by an individual that represented an officer of LNS. Such methods were not fundamentally different from those used to verify asset balances on a yearly basis, even though examinations may occur only once every 5 years, in accordance with NAIC's minimum accreditation standards. The individual who supposedly signed as the asset custodian on several asset verification documents was no longer employed by the real LNS at the time the asset certifications were made. State insurance regulators, believing they had received a certification on the assets from a legitimate entity and individual, were tricked.

On examinations completed on several Thunor Trust insurers, we found no evidence that any checks were made to validate the legitimacy or appropriateness of the custodian, LNS, or its representatives despite the unusual investment practices being pursued by the Thunor Trust insurers. The *Examiners Handbook* instructs insurance examiners to "satisfy themselves as to the integrity of the accounting controls and verification and security procedures" of the custodian. However, we found no evidence that examiners evaluated such information on the broker-dealer for years. This information could have been obtained through audits on the broker-dealer as well as policy statements on internal controls and risk management practices. Furthermore, the examination procedures did not instruct examiners to assess whether or not the insurer performed adequate due diligence on its asset custodian. Ideally, the "first line of defense" to ensure the legitimacy of the asset custodian would rest with the insurer, followed by the regulator.

One state that had adopted a key feature of NAIC's model law and regulation, requiring that only depository institutions such as banks or trust companies be used as custodians, did not properly enforce its rules. Tennessee insurance regulators allowed insurers to execute asset custodian agreements with a broker-dealer, instead of a bank or trust custodian, contrary to NAIC's guidance and Tennessee *Rules of Department of Insurance*. Furthermore, the form itself received back from LNS in 1993 was not executed properly. The document had been altered with text changes to indicate the words "bank" and "bank corporation" had been replaced with the words "securities brokerage firm." In addition, the custodial agreement had not been notarized as required. It was signed with the name of a person who was supposedly an officer of LNS, a signature that now appears to have been a phony.

Had regulators not accepted the custody agreement either for the reason that LNS was not an authorized custodian or because the form had been altered and was not notarized, the scam could have been hindered. Enforcement of the custodial requirements would have prompted LNS to return Franklin American Life's assets back to the state in 1993, thus further impeding the perpetuation of the scam. Additionally, a request to obtain a notarized signature on the custody agreement may have led to suspicions of a fraud because the signatory on the agreement was phony, as the person had supposedly already left the country.[20] Thus, a request to obtain a notarized signature may have complicated matters for the person(s) behind the scam, requiring them to find another signatory or obtain a fraudulent notarized signature.

Limited Sharing of Information and Coordination Among Regulators

Once serious regulatory concerns surfaced over insurers connected to Thunor Trust during on-site examinations, such concerns were not adequately shared with other states to help prevent further losses. Instead, state insurance regulators appeared to pursue actions that favored their own states' interests, negating opportunities for other state regulators to prevent or limit losses to their domiciled insurers.

In 1998 and early 1999, regulators in Tennessee and Mississippi raised serious concerns during their on-site examinations of insurers under Thunor Trust. The Tennessee Department of Commerce and Insurance, Division of Insurance, was conducting an examination of Franklin

[20] Our review of information at NASDR indicated that the signature of the individual in the custodial agreement differed vastly from a notarized signature of the same individual found on other SEC documents. Documentation from the examinations performed on the real LNS revealed that the person who supposedly signed the custodial agreement for the Tennessee insurer's assets in July 1993 had already left the country.

American Life while regulators in Mississippi were conducting examinations of Franklin Protective Life Insurance Company and Family Guaranty Life Insurance Company. At times, the examiners were at the same location together in Franklin, TN, where the headquarters operations for all the insurers under the Thunor Trust organization were situated. During the course of the examinations, regulators in both states raised concerns over the investment activities of insurer assets and concerns that the insurers might somehow be affiliated with LNS.

On February 1, 1999, the Examiner-In-Charge hired by Tennessee's Division of Insurance wrote a letter to the Division warning that there was a possibility that Franklin American Life had been looted of its assets. The examiner detailed the possible scam that was being perpetrated on the insurer under Thunor Trust that pointed toward an affiliation between LNS and the insurer, a scheme that is now being alleged in the federal indictment against Frankel. During our review, we found no evidence that this information was proactively shared with other state regulators to help prevent the possibility of a potential scam spreading.

After regulators in Tennessee had been informed of the possible fraud and inappropriate relationships between Franklin American Life and LNS by the Examiner-In-Charge, insurers in Arkansas and Virginia lost approximately $50 million through the scam because regulators in those states were unaware of the potential fraudulent activities that existed within Thunor Trust. Arkansas officials maintained they were not aware of regulatory concerns on entities affiliated with Thunor Trust prior to its approval of an acquisition involving Old Southwest Life Insurance Company, domiciled in Arkansas, with Franklin American Life, a Thunor Trust insurer domiciled in Tennessee. They approved the purchase on February 25, 1999. Likewise, regulators in Virginia were not aware of the regulatory concerns associated with entities connected to Thunor Trust. Settlers Life, an insurer domiciled in Virginia, fell victim to the investment scam after entering into a reinsurance transaction with one of the Thunor Trust insurance companies domiciled in Mississippi, First National Life Insurance Company of America. Given that Virginia officials were unaware of regulatory concerns on insurers affiliated with Thunor Trust, they were not able to prevent the transaction between these insurers on April 9th that ultimately resulted in the loss of approximately $45 million.

In 1998 and 1999, Mississippi regulators also had serious concerns with insurers under Thunor Trust and their investment activities with LNS. Regulatory officials in Mississippi mentioned that concerns over a possible affiliation between LNS and the insurers surfaced in the summer of 1998.

On March 12, 1999, Mississippi regulators sent a series of questions to the insurers under Thunor Trust domiciled in Mississippi. The regulators were acting on unresolved examination concerns related to the ownership interests behind Thunor Trust and the investment activities of the insurers, including a possible affiliation between LNS and the insurers. On April 8, Mississippi regulators received responses to these questions that they considered to be evasive and inconsistent. One of the more startling responses was the revelation that another entity named the "Saint Francis of Assisi Foundation, to Serve and Help the Poor and Alleviate Suffering" had supposedly become the owner of Thunor Trust and all of its insurers.

We noted a few instances where some examination concerns raised in Mississippi and Tennessee were shared with other regulators, but only in circumstances where another regulator asked for such information. Regulators in Mississippi and Tennessee shared some examination-related information with each other in late 1998 and early 1999, as examiners from both states met while conducting examinations on different insurers owned by Thunor Trust that were headquartered at the same location in Tennessee. In April 1999, when regulators from Washington State inquired about the Saint Francis of Assisi Foundation's desire to purchase an insurer domiciled in Washington, Mississippi officials warned their counterparts to proceed cautiously with the Form A approval process because of examination-related concerns over the interests behind Thunor Trust. These coordination efforts are laudable. However, a proactive alert to other states on the examination concerns raised, particularly involving a possible fraud or an affiliation between LNS and the insurers, may have afforded other regulators an opportunity to review and alert their domiciled insurers. Instead, regulators in Missouri, Oklahoma, Virginia, and Arkansas were not aware of the serious problems and concerns uncovered during the Tennessee and Mississippi examinations until the insurers collapsed in May 1999.

The NAIC examination guidelines do not require proactive communication by the state of domicile to other states that have a regulatory interest in a troubled insurer. Rather, these guidelines simply require that the state have a policy addressing these communications when requested by another insurance department. Nevertheless, insurance regulators currently have a mechanism to alert other regulators about confidential regulatory concerns within the regulatory environment.

We inquired about existing information-sharing tools available to regulators with NAIC. The NAIC information-sharing systems that are available to regulators include databases known as the Regulatory

Information Retrieval System (RIRS) and the Special Activities Database (SAD). The RIRS database is intended to convey regulatory actions against companies or individuals, and the SAD system was developed to confidentially convey areas of regulatory concern that may or may not evolve into circumstances necessitating a regulatory action or sanction. Accordingly, such regulatory concerns would be considered confidential. However, according to NAIC officials, no entries related to the Thunor Trust group of insurers were made by any states in the system to alert other insurance regulators of potential problems with the companies.

A principal concern for regulators about sharing such information relates to the implications of sharing examination-related information prior to the release of the examination report. Insurance regulators and NAIC officials acknowledge that regulators are often reluctant to share regulatory information apart from that disclosed in a published examination report. However, examination reports, because they are public documents, often do not include information that could cause negative publicity for an insurer. A key concern for regulators is the possibility that disclosure of unfavorable information may, in turn, create cause for other states to suspend the insurer's business activities, thereby exacerbating the problems for the insurer. In turn, regulators could be blamed for any harm rendered to the insurer as a result of such information disclosures.

Another information-sharing issue among insurance regulators that may have hindered regulators' ability to detect the investment scam was the lack of coordinated examination efforts focused on insurers belonging to the same group. Insurance regulators generally do not examine all affiliated companies at the same time. By 1994, the Thunor Trust family of insurers had grown to include insurers in Tennessee, Oklahoma, Missouri, and Mississippi. Concerns present among regulators in one state over the insurers' investment activities might have prompted greater awareness of these unusual activities in other states had such concerns been conveyed. Also, a call on all the insurers' assets at one time would negate opportunities to shift assets from one affiliated entity to another, or play a "shell game." Given that the scam was premised on the ability to take assets from one insurer to purchase others and, allegedly, to support Frankel's lifestyle, a proper verification of all the insurers' assets at once could have uncovered the investment scam earlier.

In addition to the lack of information-sharing within the insurance industry, insurance examiners did not generally seek information and resources available from regulators of other financial sectors. In cases where concerns were raised over the investment activities of the insurer,

regulators could have sought information and expertise from local state securities offices. Finally, in January 1999, an examiner hired by Tennessee visited the state's securities office and noted inconsistencies between the securities regulatory information available on the real LNS and the investment account information being reported to Franklin American Life by an entity named LNS. As mentioned earlier, we were able to access regulatory information on the real LNS from state securities offices through financial statements filed by the company and through the CRD system. Such information was available to insurance regulators throughout the period of the investment scam and could have helped uncover it much sooner if the regulators had accessed the information.

A Number of Corrective Actions are Planned, But Unresolved Database Issues Remain

NAIC and other state officials have proposed corrective actions to reduce the likelihood of a scam similar to that allegedly perpetrated by Frankel from happening again, but other unresolved issues could hamper future fraud prevention efforts. In addition, NAIC has proposed near-term and longer term corrective actions to remedy other insurance regulatory weaknesses highlighted by this scandal. Additionally, the Tennessee Comptroller of the Treasury, Division of State Audit, identified internal control weaknesses in the Tennessee Insurance Division, and the Division has implemented new policies designed to correct the deficiencies. Other unresolved issues that will also have an impact on future fraud prevention efforts within the insurance industry center around regulators' ability to access regulatory and criminal history data maintained by other government agencies. A key element of insurance regulators' fraud prevention efforts is their ability to prevent a rogue in another financial sector from migrating to the insurance industry. Similarly, state insurance regulators are also now faced with the challenge of fulfilling their responsibility under a federal insurance fraud prevention provision (18 U.S.C. § 1033) to prevent certain convicted criminals from engaging in the business of insurance. The extent to which insurance regulators will be able to successfully implement recommendations emanating from the Frankel case will depend on the sharing of regulatory and criminal history information across industry sectors and levels of government (state and federal agencies) and will require a continuing commitment by NAIC and the states.

NAIC Has Proposed a Series of Corrective Actions

In a report issued on April 13, 2000, NAIC's Ad Hoc Task Force on Solvency and Anti-Fraud recommended immediate and longer term corrective actions emanating from the alleged scam perpetrated by Martin Frankel. These corrective actions included recommended improvements to financial analysis and examination procedures, model laws and regulations, accreditation standards, and certain antifraud activities.

These corrective actions are detailed in the Task Force's report, which is reproduced in appendix IV. Additionally, some states have proposed other corrective actions to help prevent this type of investment scam from occurring again.

The corrective actions proposed by NAIC include those that can be implemented relatively quickly as well as longer term measures requiring adoption by the states' insurance commissioners. Some immediate and short-term corrective actions include the incorporation of an asset turnover ratio in the IRIS ratios, revisions to the *Financial Analysis Handbook* and *Examiners Handbook*, enhancements to accreditation standards, and improved sharing of information among insurance regulators. For example, improvements to accreditation standards include the adoption and implementation of a model law and regulation on the "Use of Clearing Corporations and Federal Reserve Book-Entry System." Another accreditation change proposed is a requirement for states to seek input from an investment specialist on examinations involving high risk or complex investment strategies. Concerning information-sharing activities, NAIC has proposed more proactive communications between states and the use of a "Form A database" to help states track the status of other change in ownership applications being submitted to other state regulators.

Other longer term corrective actions being proposed by NAIC, requiring the approval and adoption of the states' insurance commissioners, encompass improvements to the accreditation program, financial analysis and examination procedures, and the sharing of information outside the insurance industry. Improvements to the accreditation program include prioritizing oversight functions and instituting communication guidelines with other state and federal banking and securities regulators. Longer term enhancements to the financial analysis guidelines would consider methods for reporting and assessing financial statement data of consolidated insurance groups. Additionally, NAIC has proposed considering methods to coordinate and conduct examinations on a consolidated basis for insurers belonging to the same group. In circumstances involving troubled companies, examinations would also be required more often than once every 5 years. Other longer term actions proposed by NAIC include obtaining access to nationwide criminal history data for state insurance regulators and sharing confidential information among insurance regulators and law enforcement authorities.

NAIC has already implemented some corrective actions to revise its guidance, but other corrective measures will require sustained cooperation

from the states. Thus far, NAIC has expanded its IRIS ratio analysis to include an analysis of asset turnover. NAIC has also revised its *Examiners Handbook* to include new guidance on evaluating investment management and controls. For example, the revised guidance instructs examiners to periodically evaluate the financial condition and capabilities of bank custodians, broker-dealers, servicing agents, property managers, and others with access to the company's assets. Other corrective actions proposed by NAIC will require sustained cooperation from other state and federal agencies because changes can take several years from initial development to implementation. For instance, two of NAIC's proposals, (1) developing a process for coordinating financial examinations of insurer groups and (2) providing statutory accounting guidance that will support consolidated accounting and reporting for groups of insurers, will require further development and action by NAIC committees and, subsequently, consideration and action by each state.

Tennessee State Auditors Identified Regulatory Weaknesses Prompting Several Corrective Actions

Another investigation, conducted by auditors from the Tennessee Comptroller of the Treasury, has also prompted corrective actions by the state's insurance regulators.[21] The Comptroller of the Treasury's Division of State Audit concluded that the Tennessee Department of Commerce and Insurance failed to detect the fraudulent nature of Frankel's alleged activities before May 1999 because regulators failed to exercise sufficient professional skepticism, used inadequate procedures to review Franklin American Life, and misapplied review procedures. The audit report noted the Tennessee Insurance Division's gross breakdown in its regulation despite significant warning signs of questionable activity. The state auditors also cited a lack of communication between the Insurance Division staff and other department officials (the state's Securities Division is part of the Department of Commerce and Insurance). State investigators reported that many situations that involved unusual business transactions and circumstances were not acted upon further because department staff concluded they could take no action unless there was a law, regulation, or policy that was clearly violated. The report notes that the Insurance Division's inaction on analysts' recommendations to assess the insurer's investment activities with a securities expert, available from the Securities Division of the same department, extended the period the fraudulent scam went undetected.

[21] Special Report: Review of Inaction on the Part of Insurance Division Employees Involved in the Regulation of Franklin American Life Insurance Company, Tennessee Comptroller of the Treasury (Jul. 7, 2000).

In response to the auditor's report, Tennessee insurance regulators noted that several policy changes had been implemented. These included more detailed policies and procedures for financial analysts and examiners regarding reviewing asset custodian status, where assets are located, investment scrutiny, and supervisory review. Supervisory review procedures were also implemented regarding the analysis of the general interrogatories contained in the annual statements submitted by insurance companies and computation of asset turnover ratios and a benchmark that asset turnover should be no more than once a year. Other changes were made that were designed to strengthen documentation of activities on target exams, enhance supervisory review, and ensure record retention.

Unresolved Issues Could Hamper Future Fraud Prevention Efforts

Insurance regulators' ability to screen undesirable applicants and reduce the potential for fraud could be facilitated by improved access to regulatory and criminal history data during reviews of change in ownership and licensing applications. As mentioned earlier, insurance regulators can access NAIC's RIRS and SAD databases to obtain regulatory history information on individuals and firms in the insurance industry. However, insurance regulators generally do not have direct access to other financial regulatory and criminal databases.

Disciplinary-related data on securities brokers are maintained in CRD, available from state securities offices. Banking regulators use numerous other systems to track individuals sanctioned in the banking industry. Although NAIC has met with securities and banking regulators to discuss the sharing of information across industry sectors, insurance regulators generally do not have direct access to such systems other than through publicly available means.

Insurance regulatory access to criminal history data has been limited. NAIC officials pointed out that only a handful of state insurance departments have the ability to obtain criminal history data through agencies in their departments that have some type of law enforcement authority. Thus, NAIC officials acknowledge that insurance regulators cannot meet their responsibilities under the federal insurance fraud prevention provision, 18 U.S.C. § 1033. In contrast, banking and securities regulators routinely perform criminal history checks on individuals by submitting information to the FBI.

Justice officials we spoke to indicated that the National Crime Prevention and Privacy Compact outlines a legal framework for exchanging criminal history records between federal and state officials for noncriminal

purposes.[22] Implementation of this Compact could allow insurance regulators to access criminal history data, improving their ability to keep certain criminals out of the insurance business. Justice officials indicated that the Criminal Justice Information Services Division of the FBI would be the organization ultimately responsible for coordinating the mechanism through which the exchange of criminal history data under the Compact might be implemented. To date, insurance regulators and the FBI have not yet developed a method by which insurance regulators could conduct routine criminal history checks on individuals entering the insurance business.

In the future, insurance regulators' fraud prevention efforts could be strengthened through the assessment and review of regulatory data from banking and securities regulators and criminal history data from Justice. NAIC has proposed developing a means to query an individual's regulatory and criminal history from multiple databases in a batch process during off-peak business hours. NAIC officials maintain that such an approach would be the most efficient and effective manner to conduct routine background checks on individuals from all the states that desire to enter the insurance business. However, insurance regulators' ability to perform background checks in such a manner would require the sharing of information across different financial sectors and government agencies, as well as allowing NAIC, not itself a regulator, to serve as a clearinghouse and facilitator for such information-sharing.

Financial Modernization Highlights the Importance of Regulatory Coordination Across Financial Sectors

The consolidation of financial services industries allowed by the GLB financial modernization legislation heightens the importance of consultation and information-sharing between federal and state regulators in the performance of their respective oversight duties. The fraudulent activities allegedly perpetrated by Mr. Frankel also demonstrate the need for heightened coordination among regulators. Although the GLB Act is recent, regulators recognize 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 information and establishing 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 continued commitment to enhanced regulatory cooperation and information-sharing across financial sectors.

[22] The National Crime Prevention and Privacy Compact, Pub. L. No. 105-251, October 9, 1998 (42 U.S.C. § 14616), establishes policies and procedures for the states to access criminal history data for noncriminal purposes.

However, the regulatory coordination provision of the GLB Act is focused on regulating institutions within financial holding companies; that is, affiliated institutions that have different functional regulators. The Frankel case illustrates the importance of regulatory coordination even in the absence of a financial holding company structure.

Lessons Learned from Frankel's Alleged Scam Can Help Regulators Better Prepare for Rogues in the Future

Lessons learned from Frankel's alleged investment scam highlight the importance of sharing information between regulators of different financial sectors at different phases in the oversight process as well as adequately safeguarding and verifying insurer assets at other financial institutions.

One lesson learned from the scam was the lack of insurance regulatory tools and procedures for seeking and obtaining information from other financial sectors. At each phase in the oversight process, insurance regulators could have benefited from securities regulatory information to review ownership changes and business transactions involving individuals and entities in the securities and insurance industries. For instance, applicants desiring to engage in the business of insurance that had come from the securities industry could have been better scrutinized. Likewise, banking and securities regulators have indicated a need to properly review individuals during charter application and licensing review functions who are entering the banking or securities industry from the insurance industry. To facilitate routine regulatory background checks, regulators will have to resolve long-standing issues concerning the sharing of disciplinary-related information from databases maintained in different financial sectors.

Another lesson learned from the scam is the need to strengthen the proactive sharing of confidential information among state insurance regulators. Once regulatory concerns were raised during on-site examinations of the Thunor Trust insurers, these concerns were not proactively conveyed to other state insurance regulators to help prevent the scam from spreading to other insurers. As the distinctions between the financial sectors continue to blur, regulators of different financial sectors will need to ensure the proactive sharing of confidential regulatory information.

The Frankel case also provides a lesson relevant to efforts to implement the GLB Act, which is to recognize the importance of properly safeguarding and verifying assets across affiliated institutions in different financial sectors. Insurance regulators must consider the appropriate regulatory procedures as well as the additional accounting and auditing standards necessary to adequately verify insurer assets being held by

related parties, such as affiliate banks or securities entities. As financial services regulators coordinate their oversight efforts they must ensure that gaps are not created that could compromise their ability to obtain independent verification of transactions and assets across affiliated financial institutions.

Regulatory Coordination Efforts Recommended by the Financial Modernization Legislation Have Begun

The need for increased cooperation between federal bank regulators and state insurance regulators is clearly recognized in section 307 of the GLB Act. The section specifically states the congressional belief that the Federal Reserve Board and state insurance regulators should share, on a confidential basis, information relevant to the supervision of companies that control both a depository institution and a company engaged in insurance activities. Additionally, appropriate federal banking agencies, such as OCC, OTS, and the Federal Deposit Insurance Corporation (FDIC), should also share information with their regulatory counterparts in the insurance industry. The sharing of information, on a confidential basis, with relevant state insurance regulators should involve transactions and relationships between depository institutions and affiliated companies engaged in insurance activities. The purpose of section 307 is to encourage coordination and to thereby improve the quality and efficiency of the supervision of financial holding companies and their affiliated depository institutions and companies engaged in insurance activities.

The Federal Reserve recognizes the importance of blending its responsibilities for umbrella supervision with the functional regulation of subsidiaries or affiliates by other regulators, including insurance regulators. Federal Reserve officials explained that they have had only one situation to date necessitating close coordination with the insurance industry. This involved the merger between Citicorp and Travelers Group in September 1998. Subsequently, in August 1999, the Federal Reserve entered into a Memorandum of Understanding (MOU) with the state of Connecticut Department of Insurance, the primary regulator of Travelers, concerning the sharing of confidential supervisory information. This MOU was designed to push down to the supervisory levels of the bank and insurance affiliates the authority for examiners to talk directly to each other. Because this agreement predated the passage of the GLB Act, it is undergoing revision to reflect current law. Additional MOUs with other insurance regulators are anticipated as banks and insurance companies are merged or acquired.

In the future, Federal Reserve officials said some known issues will need to be addressed, and others may emerge. For example, the treatment of bars and sanctions that now apply only to banking agencies may need to

be extended to institutions in other financial sectors. Also, insurance companies that become part of financial holding companies are required to submit Suspicious Activity Reports to the Federal Reserve. To address these issues, the Federal Reserve is hosting Cross-Sector Regulatory Working Group meetings, two of which have been held thus far this year. Federal Reserve officials acknowledge the need for more regularized communication, although its form has not yet been established. The Federal Reserve has indicated that coordinating the regulation of Travelers/Citigroup has not presented substantial difficulty. However, in the future, when financial holding companies exist in multiple states, coordination challenges might be much more difficult.

OCC officials explained they are working to strengthen communication and coordination with the insurance industry. Specifically, they have signed an agreement for sharing complaint information with 28 states as of May 31, 2000, and anticipate signing agreements with the remaining states. They are also working toward sharing supervisory information, but to date, no agreements have been reached with any of the states. Since passage of the GLB Act, OCC has received about 30 notifications for designations as financial subsidiaries, and all but 2 have insurance-related business. Thus, OCC officials believe they will need formal sharing agreements with insurance regulators regarding supervisory information. They explained their belief that they are now legislatively walled-off from directly obtaining information on insurance affiliates absent a formal regulatory finding that an affiliated insurer would materially affect the bank and that insurance regulators are unable to adequately regulate the insurance affiliate. OCC officials noted that they could more easily obtain insurance affiliate information when needed prior to the GLB Act. For the future, OCC regulators specifically mentioned the need to share information on undesirable persons within the banking and insurance industries to reduce migration from one industry to another. They also acknowledged they would need to better understand the operations of insurance affiliates of national banks, how the insurance affiliates are regulated, and how to proceed with insurance regulators when insolvency issues arise.

Concerns about OCC's reliance on state-provided insurance information have been expressed by the Department of the Treasury Inspector General (IG), however. The Treasury IG recently warned that bank regulators may not be able to rely fully on each state's regulatory work to adequately assess the risks banks incur while selling insurance.[23] The Treasury IG

[23] Office of the Comptroller of the Currency's Supervision of Banks Selling Insurance (OIG-00-098, Jun. 27, 2000).

report mentioned that states' ability to monitor banks' insurance-related activities varied, given the varying resources and regulatory philosophy of each department. Therefore, the Treasury IG recommended that OCC proactively assess the reliance it can place on states' oversight of insurance activities performed by banks. However, OCC regulatory oversight officials did not concur with most of the report's recommendations, citing that reliance on state insurance regulatory activities is mandated by the GLB Act's functional regulatory approach.

OTS officials stated that they recognize the need for improved and continuing coordination. They also noted that insurance companies have been able to own thrifts for some time. Since 1996, OTS regulators have begun seeing increasing operational integration of the thrift with other affiliates, including insurance companies, within holding companies. Areas of increasing integration included the cross-marketing of products and the consolidation of risk management, internal control, and internal audit functions. In recognition of the trend, a regulatory cooperation and information-sharing model agreement was approved in March 2000 between OTS and NAIC, with 22 states and the District of Columbia having signed as of August 23, 2000. The remaining states are expected to sign similar agreements. The only complication that has arisen involves a couple of states with statutes barring sharing of confidential information. We also found this problem in our work on the insurance regulators' readiness for the year 2000.[24]

OTS officials also explained that in the future, areas needing attention with the insurance industry will include (1) sharing of information to guard against the migration of undesirable persons between banking and insurance; (2) ensuring that key officials of insurance company affiliates have had appropriate background checks, as now required for key officials of the affiliated thrift; (3) understanding the statutory framework for insurance in the 50 states; (4) understanding the similarities and/or gaps between insurance and thrift regulation in areas such as shifting of assets, cross-affiliate activity, employees holding dual jobs, and use of outside directors on boards of directors and committees; (5) ensuring clear disclosure of which products are insured—a special challenge with the growth of Internet marketing of products; and (6) cross-training of examiners to better understand the extent to which regulators can rely upon each others' work.

[24] Year 2000: Insurance Regulators Have Accelerated Oversight, but Some Gaps Remain (GAO/GGD-00-42, Dec. 20, 1999).

In December 1999, NAIC noted in a letter to federal regulators that mutual consultation and close cooperation would be essential to achieving the goals and requirements of the GLB Act. In particular, a need for federal-state interaction was noted for reviewing mergers and changes in management control; consultation when regulators contemplate actions affecting insurers; developing and administering effective consumer rules dealing with insurance sales practices, customer complaints, and personal privacy; and sharing regulatory information and examination findings. In March 2000, NAIC established a series of working groups to implement requirements of the GLB Act and set regulatory priorities. In the area of regulatory coordination, working groups will (1) explore all aspects of coordinating with federal regulators; (2) make recommendations regarding the analysis, examination, and review of holding companies; and (3) explore options for increased regulatory uniformity within a state-based system to achieve efficiencies.

SEC and NAIC Have Indicated a Need to Improve Regulatory Coordination

The GLB Act does not address all existing gaps or weaknesses in regulatory coordination. Beyond the efforts toward resolving database access issues to enhance fraud prevention as previously discussed, the Frankel case demonstrates, in part, a need for improved coordination between the securities and insurance regulators, even when there is no known affiliation between insurance and securities entities. In the Frankel case, had insurance regulators routinely coordinated with either state or federal securities regulators, the scam may have been detected much earlier.

The GLB Act focuses on holding company structures and bank activities; it is silent on the need for coordination between insurance and securities regulators. However, both NAIC and SEC have stated a desire to improve their coordination since the passage of the financial modernization legislation. SEC officials pointed out that prior to the GLB Act, SEC and insurance regulators had a mutual interest in variable annuity products created by insurance companies that were also deemed securities products by the courts.[25] Broker-dealers also often sell these products.

SEC also has a regulatory interest in material insurance affiliates of broker-dealers and in how financial and solvency issues of the insurance affiliate could affect the broker-dealer. These affiliations were allowed before passage of the GLB Act. NAIC has established a working group on holding companies to identify, in part, the insurance information needs of

[25] Securities and Exchange Commission v. Variable Annuity Life Insurance Co. of America, 359 U.S. 65 (1959).

functional regulators, such as SEC. In addition, as illustrated by the Frankel case, sharing disciplinary information could reduce the movement of undesirables from one industry to another. NAIC officials have told us that the current level of coordination does not extend to all areas of current regulatory concern. At this time, we are unaware of specific, direct regulatory coordination between the SEC and insurance regulators beyond the narrow issues related to annuities, or any substantive discussions on mechanisms for improved sharing of regulatory information between insurance and securities regulators.

Conclusions

Insurance companies in several states lost in excess of $200 million through an 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. Other key aspects of the scam that have been alleged included the use of aliases, fraudulent paperwork and reporting, and assistance by other individuals or entities serving as fronts. The scope and duration of this scam indicates that a number of people and entities either participated in the scam or neglected their legal, fiduciary, or contractual duties. 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, as well as 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. Additionally, 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.

Compounding the difficulties in uncovering the scam were inadequate regulatory tools, policies, procedures, and practices. In addition, long-standing information-sharing issues among federal and state financial services regulators further exacerbated the negative impacts of the scam. Most of the regulatory oversight weaknesses were related to 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 those of NAIC.

Currently, regulators generally do not routinely conduct regulatory background checks on individuals trying to enter the business of insurance. Additionally, most state insurance commissioners do not have the means to fulfill their responsibilities under a federal insurance fraud prevention provision to prevent certain convicted felons from engaging in the business of insurance. In this case, a regulatory review and inquiry of the individuals associated with Thunor Trust could have helped unravel the scam at the outset. Furthermore, the safeguards and methods used by state regulators to protect insurers' assets held by a broker-dealer did not accomplish their purpose. Adoption and enforcement of a model law and regulation developed by NAIC that identifies asset custodial requirements would have been one way to strengthen safeguards on the insurers' assets. In addition, the asset verification procedures used by regulators during examinations, generally performed once every 3 to 5 years, failed to work.

Limited or nonexistent information-sharing within the insurance industry and with securities regulators delayed detection of the investment scam for years. Additionally, the lack of information-sharing among state insurance regulators hindered efforts that might have prevented the scam from spreading to other states. Once concerns arose from examinations on insurers under Thunor Trust, such concerns were not proactively shared with other state insurance regulators to help prevent the scam from expanding. Had concerns over the possible affiliation between LNS and

the Thunor Trust insurers been shared with other state regulators in early February 1999, subsequent deals, resulting in the theft of $50 million from insurers in two other states, may have been averted. Although tools exist to facilitate proactive alerts, some regulators have been reluctant to share concerns with their counterparts in other states, citing liability or regulatory implications and the possibility that such information-sharing could further harm the insurer if other states restrict its activities. In this case, we believe that regulators confronted with the possibility of a fraud and/or an affiliation between the Thunor Trust insurers and LNS were presented with clear justification for immediately sharing this information with the other states.

In the aftermath of the scandal, we have observed a desire by the states and NAIC to address both the known inadequacies associated with the scandal as well as other areas of vulnerability. Although the corrective actions proposed to date are commendable, success in implementing them will require continued commitment by NAIC and the states, as some are expected to take several years to implement. 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.

We believe that it is too early to fully assess regulatory oversight coordination efforts emanating from the GLB 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 on the sharing of regulatory data between themselves and the banking and securities industries. Privacy and data security are legitimate concerns that will need to be addressed as information-sharing mechanisms are developed. Additionally, enhancements for safeguarding and independently verifying insurers' assets need to be addressed as affiliations between insurers, banks, and securities firms become more prevalent in the future. 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 GLB 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 need to consider regulatory data from other financial sectors to properly oversee the business relationships and transactions between institutions in different financial sectors.

Recommendations to Regulators

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 from 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 that 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 the 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 of 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.

Matter 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 insurer;

- 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

We requested comments on a draft of the report from the Insurance Commissioners of Tennessee, Mississippi, Missouri, Oklahoma, and Arkansas; NAIC; the Tennessee Comptroller of the Treasury; the Federal Reserve; OCC; OTS; SEC; NASDR; and the Department of Justice. All of the agencies chose to respond orally. These oral comments were

approved by commissioners of the state insurance departments; the President of the NAIC; the Director of State Audit, Tennessee Comptroller of the Treasury; an Associate Director and other senior officials of the Division of Bank Supervision and Regulation of the Federal Reserve, the Comptroller of the Currency, the Director of the Office of Thrift Supervision; the Assistant Chief Counsel of the Division of Market Regulation of SEC, an Associate Vice President, Enforcement Department of the NASDR; the Supervisory Assistant U.S. Attorney in Connecticut; the Deputy Chief of the Fraud Section, Criminal Division of the Department of Justice; and a Supervisory Special Agent of the Economics Crimes Unit, Financial Crimes Section, Criminal Investigative Division of the FBI.

The agencies commenting on our draft report responded orally that they generally concurred with the report's findings, conclusions, and recommendations or had no comments on the report. Officials from some agencies also provided technical suggestions that we incorporated where appropriate. Additionally, NAIC and SEC commented on implementation issues associated with our recommendation to them on enhancing coordination and information-sharing. NAIC emphasized its desire to enhance communications and information-sharing between insurance regulators and SEC and provided us with a recent letter sent by the President of NAIC to the Chairman of SEC requesting future discussions on information-sharing issues. SEC officials agreed with the need to maintain open lines of communication, but they specifically mentioned that, by statute, they could not use disciplinary information from insurance regulators in determining eligibility to license brokers. NAIC officials also noted that regulatory information-sharing could be facilitated with federal legislation allowing for and protecting the confidentiality of information-sharing between federal agencies, state regulators, and NAIC.

We are providing copies of this report to the President and 55 state and other governmental entities who are members of NAIC; the Honorable Arthur Hayes Jr., Director of State Audit, Tennessee Comptroller of the Treasury; the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System; the Honorable John D. Hawke, Jr., Comptroller of the Currency; the Honorable Ellen Seidman, Director of the Office of Thrift Supervision; the Honorable Arthur Levitt, Chairman of the Securities and Exchange Commission; the Honorable Mary L. Schapiro, President of the NASD Regulation Inc.; the Honorable Janet Reno, Attorney General; and other interested parties. We will also make copies available to others on request.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or Lawrence D. Cluff at (202) 512-8678. Key contributors to this report are acknowledged in appendix V.

Sincerely yours,

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Contents

Letter	1
Appendix I Selected Observations from Prior GAO Insurance and Securities-Related Reports	56
Appendix II Summary of Key Events Associated With the Scam Allegedly Perpetrated by Martin Frankel	60
Appendix III NAIC's Model Law and Regulation Related to Insurer Asset Custodial Requirements	64
Appendix IV NAIC's Proposed Corrective Actions Emanating From the Frankel Scandal	66

Appendix V GAO Contacts and Staff Acknowledgments 73

Tables

Table 1: Overview of Regulatory Weaknesses 16
Table 2: Summary of Asset Turnover Ratios 24
Table I.1: Selected Observations from GAO Insurance and Securities-Related Reports 57
Table II.1: Summary of Key Events 60

Figures

Figure 1: Overview of the Scandal 9
Figure 2: Simplified Structure of the Thurnor Trust Insurance Companies 12

Abbreviations

CPA	Certified Public Accountant
CRD	Central Registration Depository
FBI	Federal Bureau of Investigation
FDIC	Federal Deposit Insurance Corporation
IRIS	Insurance Regulatory Information System
LNS	Liberty National Securities
MOU	memorandum of understanding
NAIC	National Association of Insurance Commissioners
NASDR	National Association of Securities Dealers Regulation
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RIRS	Regulatory Information Retrieval System
SAD	Special Activities Database
SEC	Securities and Exchange Commission

Selected Observations from Prior GAO Insurance and Securities-Related Reports

During the 1980s, the number and size of property/casualty insurance failures and the number of insurers in danger of failure increased. In addition, in the early 1990s, several large life insurance companies failed. At the request of Congress, GAO began a series of reviews of the state-based system of monitoring insurer solvency and dealing with insurer failures. These reviews also included an assessment of the capability of NAIC to create and maintain an effective national system of solvency regulation.

As a result of these reviews, GAO found a number of weaknesses with state-based insurance regulation and NAIC's ability to both effectively monitor the essential functions of state insurance departments and establish a national system of uniform insurance regulation. At least some of these weaknesses remain. For example, the lack of interstate coordination and information-sharing about problem insurers is a regulatory oversight weakness that, in part, allowed the Frankel scheme to go undetected for many years.

In addition to the insurance-related reviews, some prior GAO observations of problems in the securities industry are relevant to the Frankel matter. Specifically, a persistent weakness observed is the difficulty for regulators to prevent the migration of unscrupulous brokers between the securities industry and other financial services industries.

Table I.1 presents selected findings from a range of GAO insurance and securities-related reports that relate to regulatory weaknesses in the insurance and securities industries.

Table I.1: Selected Observations from GAO Insurance and Securities-Related Reports

Insurance Regulation: Problems in the State Monitoring of Property/Casualty Insurer Solvency (GAO/GGD-89-129, Sept. 1989)

—Time lags in reviewing annual financial data
A company can have a problem for more than a year before a state regulator is aware of it.

—Time lags in field examinations
Most states require field examinations only once every 3 to 5 years (a few states have no statutory requirement), and such examinations can take months and sometimes years to complete.

—NAIC's warning system is of varied usefulness to states
Officials in four of the five states GAO visited generally regarded NAIC's IRIS ratios and examiner team reports as of limited usefulness when compared to their own work in annual statement analysis.

—The need for interstate coordination
Although NAIC prescribes in its Financial Regulation Standards that a state that identifies a financially troubled insurer should notify other jurisdictions in which the insurers does business, in practice, states will leave the primary responsibility for solvency monitoring to the state in which a company is located.

—States vary in the amount of information they will share about problem insurers
State regulators are divided in their policy on information-sharing between a desire to keep other departments informed and a concern that doing so may harm efforts to rehabilitate insurers.

—NAIC has had limited success in bringing states together
The extent to which states are willing or able to use the coordination opportunities (such as participation in committees, subcommittees, task forces, and working groups) provided by NAIC varied.

Insurance Regulation: State Reinsurance Oversight Increased, but Problems Remain (GAO/GGD-90-82, May 1990)

—Reinsurance data limitations affect regulatory review
Primary insurers assuming reinsurance combine primary insurance and reinsurance financial data in their annual statements. These aggregate data have not been detailed enough to reflect reinsurance activity and its impact on an insurer's financial condition.

Insurance Regulation: Assessment of the National Association of Insurance Commissioners (GAO/T-GGD-91-37, May 22, 1991)

—Limits to NAIC's authority
NAIC cannot surmount the fundamental barriers to its long-term effectiveness as a regulator because NAIC lacks authority to enforce its accreditation standards.

Insurance Regulation: The Failures of Four Large Life Insurers (GAO/T-GGD-92-13, February 18, 1992)

—Regulators' information was neither timely, complete, nor accurate
(1) Financial statements filed in accordance with statutory accounting practices did not fairly reflect the four insurers' true financial condition.
(2) An insurance holding company is not required to file consolidated financial statements based on statutory insurance accounting.
(3) Regulators relied on infrequent field examinations to verify financial data reported by the insurers. Such examinations were done about once every 3 years and took months or even years to complete.
(4) Regulators did not get financial information early enough to identify and react to the rapid deterioration in these companies.
(5) States did not keep one another informed about solvency problems, despite their interdependence in monitoring the troubled insurers.

—Holding companies are a regulatory blind spot
Regulators cannot effectively assess interaffiliate transactions if the insurer fails to report either the identity of its affiliates or the transactions. Except for infrequent field examinations, regulators have no way to verify the insurer's reported information. Interaffiliate transactions can mask an insurer's true condition, and improper transactions with affiliates have caused previous life insurer failures. In addition, an insurance holding company is not required to file consolidated financial statements based on statutory insurance accounting.

Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners (GAO/T-GGD-92-27, April 9, 1992)

—Weaknesses observed in NAIC's accreditation program
The accreditation program experienced three problems: (1) the financial regulation standards were for the most part general and have been interpreted permissively; (2) the program has too little focus on a state insurance department's implementation of its regulatory authorities, that is, how well the state does its job; and (3) the NAIC review teams' documentation of their accreditation decisions has not consistently supported their compliance decisions.

Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures (GAO/T-GGD-92-43, September 9, 1992)

—Regulator's information was not timely, complete, or accurate
The infrequency with which on-site examinations are done, even for companies known to be experiencing difficulty, significantly impairs the regulator's ability to evaluate financial condition and act on adverse findings.

Insurance Regulation: The National Association of Insurance Commissioners' Accreditation Program Continues to Exhibit Fundamental Problems (GAO/T-GGD-93-26, June 9, 1993)

—Weaknesses observed in NAIC's accreditation program
Lack of Focus on Performance Allows States With Weak Examination Quality to be Accredited

Securities Markets: Actions Needed to Better Protect Investors Against Unscrupulous Brokers (GAO/GGD-94-208, Sept. 1994)

—Potential exists for the migration of undesirable persons to other sectors of the financial services industry
GAO analyzed the records of 96 unscrupulous brokers who had left the securities industry and found that 3 of these brokers had migrated to the insurance industry. In addition, existing broker surveillance systems could be improved by enhancing the reporting of disciplinary actions and information on customer complaints into the CRD.

Insurance Regulation: Chronology of F.T. Riley's Activities and Related Regulatory Actions (GAO/OSI-95-5, Oct. 1994)

—Increased regulatory scrutiny can create incentives for insurers to redomesticate to another state
States with statutes prohibiting fraud are reluctant to investigate and prosecute insurance fraud cases because of budget and jurisdictional problems. By taking advantage of this environment, Mr. Riley and his related companies have continued to operate in a questionable manner by moving from state to state. Mr. Riley's practice was to locate an insurance company in one state but sell insurance in another state. He then claimed exemption from home state regulation on the grounds that he was a foreign insurer (an out-of-state insurer) and was not doing the business of insurance in the state of domicile. Further, when a state of domicile strengthened its laws, Mr. Riley moved the company to another state with weaker regulations.

Insurance Regulation: Observations on the Receivership of Monarch Life Insurance Company (GAO/GGD-95-95, Mar. 1995)

—Interaffiliate transactions were a regulatory blind spot
State regulators did not regulate either the parent holding companies or the noninsurance affiliates and subsidiaries of the failed insurers.

SEC Enforcement: Responses to GAO and SEC Recommendations Related to Microcap Stock Fraud (GAO/GGD-98-204, Sept. 30, 1998)

—Actions on the migration of unscrupulous brokers is not complete
No record exists of the movement of unscrupulous securities brokers.

Year 2000: Insurance Regulators Have Accelerated Oversight, but Some Gaps Remain (GAO/GGD-00-42, Dec. 1999)

—Limitations in the sharing of information among insurance regulators
State regulators have restrictions on sharing examination-related information with other state regulators.

Summary of Key Events Associated With the Scam Allegedly Perpetrated by Martin Frankel

An abbreviated chronology of key events is described in Table II.1 below. Some details have been left out to simplify what is in reality a much more complicated story. Other details are left out for sensitivity reasons. Readers should also keep in mind that ongoing criminal and civil cases are likely to provide additional details at a later date.

Table II.1: Summary of Key Events

1985-1988	Martin Frankel works in the securities industry as a registered representative. He is fired from two broker-dealers located in Ohio and Illinois.
December 1989	SEC begins a formal investigation of Frankel.
August 1991	Liberty National Securities, a small broker-dealer in Ohio, registers in Tennessee.
August 1991	SEC files a civil complaint alleging that from June 1987 to April 1988 Frankel raised over $1 million through offer and sale of limited partnerships in the Frankel Fund. Frankel then made omissions and misstatements about the use of proceeds from investors, Frankel's background and experience, and the Frankel Fund performance.
September 1991	Frankel allegedly arranges the formation of Thunor Trust using three nominee grantors. The Tennessee State Department of Insurance receives the Form A filing and later approves the Thunor Trust's acquisition of Franklin American Corporation and its subsidiary company Franklin American Life Insurance Company.
August 1992	Frankel settles with SEC consenting to a bar from the securities industry and disgorgement of funds.
March 1, 1993	The Tennessee State Department of Insurance receives Franklin American Life Insurance Company's December 31, 1992, annual financial statement. The statement shows that (1) the value of Franklin American's U.S. government securities increased 28% from the prior year's end, and (2) Franklin American's entire portfolio of these securities "turned over" 17 times during the year. The CPA firm issued a clean opinion.
April 1993	Liberty National Securities moves from Toledo, OH to Dundee, MI.
June 1993	The Tennessee State Department of Insurance begins an examination of Franklin American Life as of December 31, 1992. The examination report is issued April 1994 with no adverse material findings.
February 1994	Family Guaranty Life Insurance Company domiciled in Mississippi is purchased by an affiliate of Thunor Trust.
February 25, 1994	The Tennessee Department of Insurance receives Franklin American Life Insurance Company's year-end 1993 annual financial statement showing that (1) the value of Franklin American's securities portfolio increased by 53% from the prior year's end, and (2) Franklin American's entire portfolio of securities "turned over" 40 times during the year.
March 1994	Farmers and Ranchers Life Insurance Company domiciled in Oklahoma is purchased by an affiliate of Thunor Trust.
August 1994	International Financial Services Life Insurance Company domiciled in Missouri is purchased by an affiliate of Thunor Trust.

February 25, 1995	The Tennessee Department of Insurance receives Franklin American Life's year-end 1994 financial statement showing that (1) the value of Franklin American's securities portfolio increased by 3% from the prior year's end, and (2) Franklin American Life's entire portfolio of securities "turned over" 172 times during the year.
March 1995	Family Protective Life Insurance Company domiciled in Mississippi is acquired by an affiliate of Thunor Trust.
February 29, 1996	The Tennessee Department of Insurance receives Franklin American's year-end 1995 annual financial statements. They show that (1) the company's securities were "held by broker in street name" in violation of Tennessee custody regulations, (2) the value of Franklin American's securities portfolio increased by 14% from the prior year's end, and (3) Franklin American's entire portfolio of securities "turned over" 245 times during the year.
April 25, 1996	A routine exam completed of Farmers and Ranchers (Oklahoma) with an "as of" date of December 31, 1994. There are no material adverse findings.
September 25, 1996	A target examination is conducted of Franklin American Life Insurance Company's securities investments by Tennessee State Insurance Department because of concerns that Franklin might be engaged in "short-selling" its government securities, i.e., selling a security before it is actually owned. After a 1-day on-site review, staff members conclude the company is not short-selling but recommend that a securities expert be retained to examine Franklin American's securities investments.
February 26, 1997	The Tennessee State Insurance Department receives Franklin American's year-end 1996 annual financial statement. This statement indicated the value of Franklin's securities portfolio increased by 19% from the prior year's end and that the portfolio of securities turned over 167 times during the year.
May 1997	Missouri's routine exam of International Services Life is made public and has an "as of' date of December 31, 1995. There are no material adverse findings in the exam report.
January 1998	Mississippi State examiners begin a routine exam of both Family Protective Life Insurance Company and Family Guarantee Life Insurance Company with an "as of date" December 31, 1997. During this exam, examiners were aware the securities were with a broker and that this did not violate state law. They also had trouble confirming the relationship of the broker, Liberty National Securities of NY, and confirming that the broker had the securities in its possession. By fall 1998, Mississippi officials had a draft report saying that FAC was not reporting the ultimate controlling person. This exam continues until January 29, 1999.
February 1998	First National Life Insurance Company domiciled in Alabama is purchased by an affiliate of Thunor Trust.
March-May, 1998	Thunor Trust officials and representatives meet with Alabama Insurance officials to advise that they intend to terminate the existing custodial agreement with a bank holding the marketable securities and transfer them to a brokerage with a national reputation. Alabama regulators deny the request because broker-dealers are not permitted to be custodians under Alabama law. Two years later Alabama regulators learn that nearly $100 million was removed from the bank custodian anyway and in violation of the custodial agreement that required regulatory approval for withdrawals.
May 11, 1998	Oklahoma completes its second routine exam of Farmers and Ranchers since purchase by Thunor Trust with "as of" date of December 31, 1997. There are no material adverse findings.
September 1998	An independent contractor for the Tennessee Insurance Department begins his examination of Franklin American Life Insurance Company with an "as of" date of December 31, 1997.
September 29-30, 1998	First National redomesticates in Mississippi from Alabama.

October 1998	The St. Francis of Assisi Foundation, another investment vehicle allegedly controlled by Frankel, files a Form A application with the Colorado Division of Insurance to purchase an insurance company. The Colorado Division of Insurance advises the foundation that the Form A filing is incomplete and requests additional information. A purchase is never approved.
Late 1998	The Tennessee examination reveals that the insurer was placing nearly all of its assets with Liberty National Securities, apparently in violation of state rules that require assets to be held by a bank custodian. Tennessee insurance regulators issue an order requiring the insurer to retrieve its investment assets and put them in a bank. Franklin American Life Insurance Company's securities are, for the first time, placed in a qualifying banking institution, effective December 31, 1998. However, soon into the next year, the assets are removed again.
January 14, 1999	A Thunor Trust affiliate files a Form A application to purchase Old Southwest Life Insurance Company domiciled in Arkansas. Arkansas regulators approve the purchase in February 1999.
January 1999	The contract examiner for the Tennessee Insurance Department has problems getting custodial information on the bonds held by Liberty National and reference material on Liberty National. Tennessee regulators meet with officials under the Thunor Trust umbrella to discuss concerns about the lack of public information on Liberty National, the bond trading strategy's apparent lack of logic, why brokerage fees are so low, bond custodial issues under Tennessee law, and other matters. Afterward, the Tennessee contract examiner obtains information on Liberty National from Tennessee securities regulators that shows geographic location and firm size inconsistencies with material received from the Thunor Trust affiliates.
January 29, 1999	Mississippi examiners have their closeout conference with Thunor Trust representatives. They also receive the information obtained from the Tennessee securities regulators showing the inconsistencies about Liberty National's location and size. The examiners tell the Thunor Trust representatives they are taking their concerns about asset verification and Liberty National's affiliation to their superiors.
February 1, 1999	The Tennessee contract examiner sends a memo to the Insurance Department Chief Examiner noting the possibility that the Tennessee insurance company has been looted of its assets. He notes that fraud would explain some otherwise unexplainable information, including (1) the grantors giving the sole trustee irrevocable control over millions with no contractual assurance that it be returned to the grantors or their beneficiaries; (2) use of a little known brokerage firm for massive bond transactions; and (3) the expertise/secretive process, which permits the Tennessee insurance company to consistently record exceptional gains on bond trades but prevents the bonds from being under a custodial arrangement with a bank or trust company.
February 8, 1999	Tennessee State Department of Insurance officials grant a 60-day grace period to the Tennessee insurance affiliate of Thunor Trust to move its securities to a Tennessee bank. Liberty National Securities now has until April 1999 to return the assets.
February 23, 1999	Mississippi insurance officials talk to representatives of the Thunor Trust Tennessee affiliate by phone and once again are told that Liberty National Securities is not an affiliated entity of Thunor Trust.
February 25, 1999	Old Southwest Life Insurance Company, domiciled in Arkansas, is approved for purchase by an affiliate of Thunor Trust.
February-April 1999	Mississippi regulators send questions to the appropriate affiliates of Thunor Trust about their concerns and later receive written answers. Copies of the questions are also sent to Tennessee regulators.
Early April 1999	The Thunor Trust affiliate, First National Life, domiciled in Mississippi, enters into an approximately $44 million reinsurance agreement with Settlers Life Insurance Company domiciled in Virginia.

April 28, 1999	Meeting in a Jackson, MS hotel reportedly attended by Frankel and others to discuss the meeting the next day with Mississippi regulators.
April 29, 1999	Mississippi regulators decide to place all three Mississippi companies under administrative supervision after the meeting between the Mississippi Department of Insurance and insurance company officials of the Mississippi domiciled companies.
May 3, 1999	Mississippi regulators go to Franklin American to take control of the Mississippi companies.
May 4, 1999	First time Mississippi regulators look at documents belonging to First National Life Insurance Company of America.
May 5, 1999	Greenwich, CT police and firefighters responded to the burning of Frankel's $3 million estate.
May 7, 1999	Sole trustee of Thunor Trust signs affidavits acknowledging that the whereabouts of the money belonging to the insurance companies under the trust was unknown. Mississippi insurance officials contact the FBI.
May 8, 1999	Mississippi regulators meet with Mr. Heath of Leuty & Heath, the CPA firm for the Frankel companies. Heath kept very few records. Mssrs. Leuty and Heath were the only CPAs in the firm. The Frankel companies were apparently the primary clients.
May 10, 1999	Mississippi regulators place three Mississippi companies into receivership.
May 11, 1999	The Tennessee Department of Commerce and Insurance confirms its request that Franklin American Life Insurance Company place $57.5 million of its assets into a Tennessee bank, and the money is transferred. The Arkansas, Alabama, Oklahoma, and Virginia regulators first become aware of the apparent fraud.
September 4, 1999	Frankel is taken into custody in Hamburg, Germany.
October 7, 1999	U.S. Attorney/Connecticut files criminal indictment alleging Frankel stole in excess of $200 million in cash reserves from the insurance companies he controlled anonymously. Following the theft, the funds were used to purchase cars, real estate, diamonds, and gold.
December 3, 1999	David Rosse, a bodyguard and associate of Frankel, pleads guilty to one racketeering conspiracy charge in Federal District Court (Connecticut).
December 27, 1999	Karen Timmins, an office assistant to Frankel at his Connecticut mansion, pleads guilty to one count of concealing the laundering activities of others and failing to report them to authorities.
March 23, 2000	An NAIC committee votes to suspend Tennessee's accreditation largely because of the Frankel matter.
March 27, 2000	Philip Miller pleads guilty to one count of conspiracy in Federal District Court (Connecticut).
June 2000	Martin Frankel pleads guilty to tax evasion in Germany in connection with diamonds he purchased and transported into the country but appeals the sentence.

NAIC's Model Law and Regulation Related to Insurer Asset Custodial Requirements

In the mid 1990s, NAIC reaffirmed that broker-dealers should not be used as custodians for insurer assets.[1] In 1993, a working group was appointed to study the issue of whether or not broker-dealers should serve as custodians for insurers' assets. After collecting position papers from interested parties, including those representing broker-dealers, the NAIC working group expressed concerns over the safeguards present on insurers' assets should the broker-dealer become insolvent and concluded that safeguards for insurers' assets with banks and trusts were superior to those of broker-dealers. Furthermore, the working group noted that additional costs that may be associated with using banks or trust companies as custodians would not be significant to most insurers. The working group concluded in 1994 that NAIC's existing policy to exclude broker-dealers from serving as custodians of insurer assets be maintained.

NAIC's Model Law No. 295 and Model Regulation No. 298 have not been adopted in many states, in part, because such adoption is not a requirement for state accreditation by NAIC. As part of its accreditation program, NAIC requires that states adopt certain model laws and requirements, or substantially similar laws and requirements, to receive accreditation. These accreditation standards do not currently include this particular model law related to the custody of assets. Although many states have laws related to asset custody requirements, NAIC officials could not say definitively how many states allowed institutions other than banks or trust companies to act as custodians for insurer assets.

During our discussions and reviews of regulatory files at the insurance departments we visited, we found that Tennessee, Mississippi, Missouri, and Oklahoma allowed a broker-dealer entity, LNS, to maintain the custody of insurers' assets, contrary to NAIC's model law and regulation. One of these states, Tennessee, had adopted the use of NAIC's model custody agreement, but it did not enforce the agreement properly between Franklin American Life and LNS. Instead, Tennessee Insurance Division officials allowed the insurer to place its assets in the custody of a broker-dealer for years, contrary to NAIC's model law and regulation that required the insurer to place its assets in a bank or trust company. Later, the state retrieved approximately $57 million of insurer assets into an approved account by enforcing state rules regarding asset custody arrangements, which were based on NAIC's guidelines.

[1] According to NAIC officials, an acceptable trust under the model law could include a trust company that was a subsidiary to a securities firm.

One state hindered the alleged investment scam through the enforcement of its insurance requirements that prohibited broker-dealers from maintaining custody of an insurer's assets. In 1998, after an insurer domiciled in Alabama was purchased under Thunor Trust, company officials requested that insurance regulators allow the insurer to invest its assets with LNS. State officials denied the request, citing state requirements that an insurer's assets be maintained in a bank or trust, similar to those recommended in NAIC's model law. Subsequently, the insurer, First National Life Insurance Company of America, redomesticated to Mississippi, where a similar requirement did not exist. Unfortunately, the insurer's assets were stolen through the bogus LNS operation Frankel allegedly established. The evidence now suggests that officials connected to Thunor Trust pulled out the assets of the Alabama insurer prior to the redomestication to Mississippi, in violation of Alabama's rules and without the Alabama Insurance Department's knowledge.

NAIC's Proposed Corrective Actions Emanating From the Frankel Scandal

NAIC

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

EXECUTIVE HEADQUARTERS
2301 McGee Street
Suite 800
Kansas City MO
64108-2604
voice 816-842-3600
fax 816-783-8175

FEDERAL AND INTERNATIONAL RELATIONS
Hall of the States
444 North Capital St NW
Suite 701
Washington DC
20001-1512
voice 202-624-7790
fax 202-624-8579

SECURITIES VALUATION OFFICE
7 World Trade Center
19th Floor
New York NY
10048-1102
voice 212-285-0010
fax 212-285-0073

WORLD WIDE WEB
www.naic.org

Date: April 13, 2000

To: Members of the Executive (EX) Committee

From: Members of the Ad Hoc Task Force on Solvency and Anti-Fraud

Re: Final Report and Recommendations

The Executive (EX) Committee established the task force to gather input on possible improvements to regulatory programs and practices as a result of the alleged fraud scheme involving Martin Frankel and a number of insurance companies. The task force received suggestions from states directly affected by this situation, from other state regulators, and from NAIC staff. All of the suggestions were reviewed by the task force and from them, a series of recommendations have been prepared.

The recommendations of the task force have been grouped according to priority and suggested course of action for implementation as follows:

Level One

These items are generally the highest priority items that can be accomplished relatively quickly and that should not involve significant NAIC or state resources.

Level Two

These are initiatives that overlap current projects of other NAIC groups, primarily the GLBA National Regulatory Priorities Working Groups. Although many of these items are considered priorities of the task force, they also appear high on the membership's overall agenda so no further action is considered necessary at this time. However, the task force would like to endorse these initiatives for additional urgency.

Level Three

These are initiatives that may require lengthy discussions and development or that involve significant additional NAIC or state resources. They are no less important to the task force but are likely to require careful planning, organization and funding to complete. The task force has identified potential committees and charges to oversee these projects.

Attachment

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Final Report and Recommendations
Ad Hoc Task Force on Solvency and Anti-Fraud

LEVEL ONE

A. Accreditation Standards and Guidelines

1. Recommend that the Model Law and Regulation to permit the Use of Clearing Corporations and Federal Reserve Book-Entry System by Insurance Companies become a Part A Accreditation Standard.

2. Add a review team guideline to the "Use of Specialist" examination standard for investment expertise. Currently, the Use of Specialist standard includes guidelines for computer and audit expertise, reinsurance expertise and actuarial expertise. Adding a guideline for investment expertise would require states to obtain expert assistance on examinations of insurers having high risk or complex investment strategies.

3. Add a review team guideline under the "Communications with States" and/or "Procedures for Troubled Companies" that would require proactive communication by the domestic state to other states that have a regulatory interest in a troubled insurer. Currently, the exam team guidelines simply require that the state has a policy addressing these communications when requested by another insurance department. The guidelines should require proactive communication, define criteria for states with a regulatory interest, and require an evaluation of the sufficiency and timeliness of those communications.

4. Adopt an Accreditation Team Guideline requiring use of the "Form A" Database (see discussion of Form A database below).

The task force recommends that the above items be referred to the Financial Regulation Standards & Accreditation (F) Committee with a strong recommendation to invoke Section II, Waiver of Procedure of the NAIC's Procedure for the Adoption of Additional Model Laws, Regulations or Standards for Accreditation at the NAIC 2000 Fall National Meeting to expedite adoption of these changes to the standards. The task force further recommends that the committee consider establishing effective dates for these new standards as early as practicable.

B. Financial Analysis and Examinations Procedures

1. Add an evaluation of investment management practices to the Level One Checklist of the Financial Analysis Handbook. This element should be included in the handbook to better understand the insurer and its business and to better assess the risk of insolvency due to investment problems.

   This item should be referred to the Financial Analysis Handbook Working Group with a charge to have it completed by the NAIC 2000 Winter National Meeting.

2. Develop additional examination procedures in the investment SRA designed to evaluate the investment management practices of the insurer. These procedures should consider risk factors such as the use of third party investment advisors, significant changes in the

investment portfolio and significant trading volume or changes in trading volume. Further, procedures should be developed for coordinating the use of investment specialists similar to the existing procedures for actuarial specialists.

This item should be referred to the Financial Examiners Handbook Working group with a charge to be completed by the NAIC 2000 Winter National Meeting.

C. Annual Statement Blanks and Instructions

1. Adopt an Interrogatory affirming that insurer's investments are in custody at a qualified bank or are on deposit with the insurance commissioner.

2. Adopt a related Interrogatory addressing whether there has been a change in the bank that has custody of the insurer's investments.

The above items should be referred to the Blanks (E) Task Force with a charge for completion by the NAIC 2000 Fall National Meeting with addition to the *NAIC Annual Statement Blanks* as soon thereafter as possible.

D. Form A Database

Create a Form A database for use with the NAIC I-SITE platform with the following data elements:

1. State Submitting Data;
2. Date of Form A application;
3. Contact person and contact information for state submitting data;
4. Application Status (i.e., pending, approved, denied or withdrawn);
5. Names and addresses of the applicant's directors, executive officers, and 10% or more owners of voting stock; and
6. Names and addresses of affiliated persons or companies.

The Financial Condition (E) Committee should be charged with developing specifications for this database by the NAIC 2000 Fall National Meeting. The committee would then coordinate development of the database with the NAIC Information Systems Division under the direction of the Information Systems (G) Task Force with the objective of completing a prototype by the NAIC 2001 Summer National Meeting.

E. Anti-Fraud

1. Engage in discussions with the National Association of Securities Dealers to explore shared database access for information relating to insurance producers.

2. Compile detailed information on anti-fraud databases maintained by anti-fraud organizations, financial regulators, and law enforcement, and identify criteria for access.

3. Where members can meet current criteria for access to databases discussed in paragraph (E)(2), negotiate agreements and encourage member states to utilize those sources of data.

4. Establish guidelines on the investigative and prosecutorial resources necessary to investigate insider insurance industry fraud, based on such parameters as volume of insurance premiums written, the nature of the industry activity, population, and other objective measures.

5. Consider modifications to the Insurance Fraud Prevention Model Act, including addressing such issues as specific and detailed authority to investigate insider insurance industry fraud; law enforcement status of investigators; and provisions granting prosecution authority, or other alternative structures to obtain dedicated prosecution resources.

Item one should be referred to the NARAB working group; items two through five should be referred to the Anti-Fraud (G) Task Force; and, with respect to item three, the Coordinating with Federal Regulators Working Group should also be given a charge to coordinate with federal regulators. Charges to be completed by the NAIC 2000 Winter National Meeting.

F. Improvements to Model Laws and Regulations

1. Modify the Model Law and Regulation to Permit the Use of Clearing Corporations and Federal Reserve Book-Entry System by Insurance Companies to require a notice of termination by the custodian to the insurance department in the event an insurer withdraws a significant percentage of the assets in custody.

2. Review the Model Regulation Requiring Annual Audited Financial Reports and consider modifications regarding notice to insurance departments when an insurer changes auditors.

These items should be referred to the Financial Condition (E) Committee with a charge to complete by the NAIC 2000 Winter National Meeting.

LEVEL TWO

The task force believes that the following proposals are encompassed in the charges of the Insurance Holding Company/Analysis/Examination/Review Working Group and the Coordinating with Federal Regulators Working Group.

G. Coordinated Financial Examinations

1. Develop a process for coordinating financial examinations of insurer groups. The proposal is for a lead state to coordinate the timing of all other states' examinations of insurers that are part of a consolidated group. Each state would issue exam reports on their domestic insurers and in addition, the lead state would issue an exam report on a consolidated basis for the entire group.

2. Develop statutory accounting guidance that will support consolidated accounting and reporting for groups of insurers.

H. Financial Analysis of Consolidated Entities

1. Develop a process for financial analysis of consolidated insurance groups. The proposal contemplates a two-tier process:

   a. The NAIC Financial Analysis Division will analyze GAAP financial statements, information obtained from the Federal Reserve, and other available information on Financial Holding Companies. Reports will be provided to states with a regulatory interest.

   b. The states will analyze consolidated financial information on consolidated groups comprised solely of insurance companies and insurance related entities.

2. Develop Annual and Quarterly Statement reporting requirements that will support consolidated statement filings.

I. Procedures for Holding Company Filings

Develop standard review processes and procedures for holding company filings. These procedures should include input of data to the Form A database discussed above.

J. Improvements to Model Laws and Regulations

Consider modifying the Model Regulation Requiring Annual Audited Financial Statements to require consolidated GAAP and SAP audit reports. GAAP audit reports would be useful to support financial analysis of Financial Holding Companies and SAP audit reports would support the analysis of insurance company groups.

LEVEL THREE

K. Accreditation Standards and Guidelines

The Financial Regulation Standards & Accreditation (F) Committee should be assigned the following charges:

1. Consider adopting a review team guideline requiring that significant elements of Part A standards are reviewed during the financial analysis and financial examination processes.

2. Consider revisions to accreditation scoring including both the weighting of scores and the review team guidelines for scoring.

3. Consider adding review team guidelines that would require examination of troubled or first priority insurers more often than once every five years.

4. Consider adding review team guidelines requiring better communications with other state insurance regulators and state and federal banking and securities regulators. (This initiative could overlap with the Coordinating with Federal Regulators Working Group chaired by Commissioner Vaughan.)

The committee should prepare a preliminary workplan for each of these charges by the NAIC 2000 Fall National Meeting.

L. Financial Analysis and Examinations

The Financial Condition (E) Committee should be assigned the following charges:

1. Consider adding guidance in the Level One Checklist of the *NAIC Financial Analysis Handbook* and to the *NAIC Financial Condition Examiners Handbook* requiring that significant elements of Part A standards be reviewed during the financial analysis and financial examination processes.

2. Consider developing more specific guidance for the *NAIC Financial Condition Examiners Handbook* regarding scheduling of exams. The timing of financial exams should be more closely related to the risk of insolvency and more use of limited scope/targeted exams should be encouraged.

3. Consider developing guidelines for the *NAIC Financial Condition Examiners Handbook* that will emphasize evaluating the risk assessment practices and risk management processes of insurers. Further, the handbook should increase its emphasis on understanding, testing and relying on insurers operational controls vs. extensive substantive testing procedures. (This initiative is currently being evaluated by the Financial Reporting (E) Working Group chaired by Commissioner Vaughan.)

The committee should prepare a preliminary workplan for each of these charges by the NAIC 2000 Fall National Meeting.

M. Improvements in Anti-Fraud Efforts

The Anti-Fraud (G) Task Force should be assigned the following charges:

1. Establish a working group to recommend alternatives to provide expert assistance to state insurance departments investigating fraud, including interstate exchanges of assistance, grant funded programs from both public and private sources, and increased resource capabilities at the NAIC.

2. Establish a goal to obtain NCIC access for state insurance regulation to use for licensing and investigation purposes, and pursue through either federal legislation or Executive Order.

3. Recommend a structure to facilitate confidential information exchange between insurance fraud investigation and prosecution authorities, which would provide secure protection for sensitive investigative information.

The Task Force should prepare a workplan for each of these charges by the NAIC 2000 Fall National Meeting.

N. Improvements to Model Laws and Regulations

The Financial Condition (E) Committee should be given the following charge and prepare a proposed workplan by the NAIC 2000 Fall National Meeting.

> Study the Assumption Reinsurance Model Act and the Disclosure of Material Transactions Model Act to determine whether significant reinsurance transactions should require prior notification or approval.

O. *NAIC Troubled Companies Handbook*

The Financial Condition (E) Committee should be given the following charge and prepare a proposed workplan by the NAIC 2000 Fall National Meeting.

> Review and consider improvements to the *NAIC Troubled Companies Handbook*, especially the section on causes of potentially troubled companies.

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GAO Contacts and Staff Acknowledgments

GAO Contacts

Richard J. Hillman, (202) 512-8678

Lawrence D. Cluff, (202) 512-8678

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