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YEAR 2000

State Insurance
Regulators Face
Challenges in
Determining Industry
Readiness



General Government Division

B-281368

April 30, 1999

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

This report responds to your request that we study the readiness of the insurance industry to meet the Year 2000 date change. Our objectives were to determine (1) what state regulators were doing to oversee the Year 2000 readiness of the insurance industry, (2) how the regulatory oversight of the insurance industry's Year 2000 readiness compared with the oversight of the banking and securities industries,¹ (3) the current status of the insurance industry's Year 2000 readiness, and (4) the nature and extent of Year 2000 liability exposures that insurers face and the mitigation efforts taken to address such exposures.

Results in Brief

The 17 state insurance regulators we visited differed in their approach and level of oversight activity directed to the insurance industry's Year 2000 readiness. These state regulators also differed in how they assessed and ranked insurance companies in terms of Year 2000 readiness. Such variations raise a question about the extent to which states can rely on one another's judgments regarding the preparedness of nondomiciled insurance companies doing business in their states.² This question is especially applicable to those states where the level of Year 2000 oversight is relatively limited or the criteria for assessing readiness may be considered lax. Variations in oversight approaches among state regulators also made it difficult to ascertain the overall status of the insurance industry's Year 2000 readiness.

Regulatory oversight of the insurance industry's Year 2000 readiness began later than the oversight of the banking and securities industries. In general, the state insurance regulators we visited were less active in their efforts to

¹Preliminary observations comparing the Year 2000 oversight of the banking, securities, and insurance industries were first reported in a statement for the record, Insurance Industry: Regulators Are Less Active in Encouraging and Validating Year 2000 Preparedness (GAO/T-GGD-99-56, Mar. 11, 1999).

²Although an insurer can be licensed and conduct business in multiple states, the regulator in the state where the insurer is chartered is its primary regulator. The chartering state is referred to as the state of domicile. Other states where insurers are licensed (but not chartered) generally rely on the supervisory oversight of the company's primary regulator.

promote Year 2000 readiness and efforts to validate information on the status of companies' readiness. They were also less active in planning for and pursuing formal enforcement actions against companies identified as inadequately preparing for 2000 and at a high risk of not being ready for the millenium change. In addition, the National Association of Insurance Commissioners (NAIC), which is a key facilitator of states' oversight efforts, was generally late in providing information and guidance to state regulators about the appropriate Year 2000 regulatory activities to undertake.

Regulatory information on the Year 2000 readiness of the nation's insurance industry, consisting primarily of self-reported information obtained through surveys, does not provide the necessary information to judge whether the industry will be ready for 2000. Nonetheless, insurance regulators and also other observers we contacted generally have a favorable view of the industry's Year 2000 readiness. These regulators and industry observers expressed confidence that companies were actively preparing for the Year 2000 date change because of competitive pressures and the business need to process date-sensitive information before 2000 (e.g., calculating annuity payments extending beyond 2000).

The magnitude of insurers' Year 2000-related liability exposures cannot be estimated at this time, and the effectiveness of efforts to mitigate these exposures remains uncertain. While not yet estimable, costs associated with Year 2000-related exposures could be substantial for some property-casualty insurers, particularly those concentrated in commercial market sectors, due to potential claims and legal defense costs. Despite efforts to mitigate potential exposures, the Year 2000-related costs that may be incurred by insurers will remain uncertain until key legal issues and actions on pending legislative initiatives are resolved.

Background

The insurance industry, with policy reserves of approximately \$2.5 trillion, is an important component of the financial system. These reserves are held in trust for policyholders, much like bank deposits are held for depositors. While there are important similarities between insurance companies and other financial intermediaries, there are important differences as well. One difference is that policy reserves are paid out when policyholders experience an insured loss. Thus, policyholders may get back more or less than they paid the insurance company. This is unlike a bank deposit, where bank depositors can expect to get their deposits, plus interest. A similarity between insurance companies and banks is that both use the money they receive to purchase income-earning assets until the money is needed. Furthermore, like banks and securities dealers, insurance

companies are regulated to ensure that the money they collect now will be available to meet later obligations. To a large extent, it is the delayed delivery of the contracted product that makes the importance of addressing Year 2000 issues particularly acute in the financial services industry in general and in the insurance industry in particular.

The Year 2000 problem exists because the data that computers store and process often use only the last two digits to designate the year. On January 1, 2000, such systems may mistake data referring to 2000 as meaning 1900, possibly leading to numerous errors and disruptions in processing. Financial services institutions are especially dependent upon the accurate transmission of electronic information; thus, the systems they use must be readied to correctly process 2000 dates.

To provide a standard gauge for assessing the progress of federal agencies in becoming prepared for the Year 2000 date change, we issued guidance in 1997.³ While this Assessment Guide is directed specifically at federal agencies, the stages of Year 2000 preparation and corresponding milestones can generally be applied to all institutions, including private companies. The Assessment Guide discusses issues that are common to nearly all companies, as well as to the federal agencies, and can be used as a general measure of whether a company is on track to being prepared for the Year 2000 date change. Thus, a regulator of financial institutions could use this, or other similar guidance, as general criteria for assessing the state of preparedness of its regulated institutions.

The Assessment Guide divides the process by which an institution could become Year 2000 compliant into five phases—awareness, assessment, renovation, validation, and implementation. Each of these phases is described in appendix I. The final deadline for becoming ready for 2000 is immovable. Furthermore, since the phases of preparation are sequential, it is important to establish intermediate milestones to help ensure that a company will be able to complete all Year 2000 preparations in time. A schedule for measuring progress toward Year 2000 readiness could allow regulators a degree of comfort concerning the status of their regulated companies. As shown in table 1, the Assessment Guide provides a schedule of suggested completion dates for each of the key phases of Year 2000 conversion.

³Year 2000 Computing Crisis: An Assessment Guide (GAO/AIMD-10.1.14, Sept. 1997).

Table 1: Year 2000 Conversion Phases and Suggested Completion Dates

Year 2000 conversion phase	Suggested completion date
Awareness	December 1996
Assessment	August 1997
Renovation	August 1998
Testing and implementation	December 1999

Source: GAO/AIMD-10.1.14.

Other parties have developed alternative sets of phases and milestones. Subsequent to the issuance of our Assessment Guide, the Office of Management and Budget (OMB) provided standards that federal agencies are expected to follow. OMB's milestones begin with the assessment phase, which was to be completed by June 30, 1997, followed by renovation, validation (internal testing), and implementation. All entities are to have completed the implementation phase by March 31, 1999. After that date, entities are to be engaged in testing of business processes and planning for contingencies. Throughout the remainder of this report, actions by insurance regulators are compared to the guidance found in our Assessment Guide.

Year 2000-related system malfunctions in an insurance company can have serious business interruptions and even solvency implications. Specifically, Year 2000 problems could result in disruptions to processing policyholder payments and investments, insurance claims and payments, annuity payments, and data queries to verify insurance coverage. This means that some policyholders may be unable to obtain policy service, or worse, may be unable to collect on their policies at a time of need. It is also possible that the delivery of health care services could be affected if health insurers cannot readily process claims information.

Pursuant to the McCarran-Ferguson Act of 1945,⁴ states exercise primary regulatory jurisdiction over the insurance business. Each state has a department of insurance that, among other things, is responsible for monitoring insurance companies' solvency. Solvency, in turn, can be affected by operational issues, such as the failure to be ready for 2000.

Companies that operate and write insurance policies in multiple states comprise much of the nation's insurance industry. Although an insurance company can conduct business in multiple states, it is incorporated, or chartered, under the laws of a single state, which is referred to as its state of domicile. The regulator in an insurer's state of domicile represents its primary regulator and is to assume lead responsibility for oversight issues,

⁴15 U.S.C. sections 1011-1015.

such as Year 2000 readiness. States where insurers are licensed to operate (but not chartered) generally rely on the companies' primary regulator to exercise due diligence in overseeing domiciled companies and to voluntarily share information about them.

Role of the National Association of Insurance Commissioners

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 any regulatory authority over the state insurance departments. NAIC provides a national forum for resolving major insurance issues and for allowing regulators to develop consistent policy 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. Although it has no regulatory function, NAIC is responsible for (1) serving as a clearinghouse for exchanges of information, (2) providing a structure for interstate cooperation in examinations of multistate insurers, (3) distributing model insurance laws and regulations for consideration by state legislatures and insurance departments, and (4) reviewing state insurance departments' regulatory activities as part of a national accreditation program. Regarding Year 2000 issues, NAIC has assumed a key role as facilitator of states' efforts to oversee the industry's readiness. This role includes acting as a coordinator of information pertaining to state oversight efforts, the status of the industry's readiness, and state regulators' actions to become internally prepared for 2000.

Scope and Methodology

To determine what regulators were doing to oversee the Year 2000 readiness of the insurance industry, we interviewed officials of NAIC and reviewed available information on the organization's efforts to facilitate states' Year 2000 activities and summarize information in the area. We also visited 17 state insurance departments whose domiciliary companies collectively accounted for 75 percent of insurance sold nationally.⁵ In late January 1999, we surveyed these 17 state regulators to obtain an update on their Year 2000 oversight activities, including their efforts to set priorities for reviewing domiciled insurers. Unless otherwise indicated, observations throughout this report regarding state efforts and activities pertain specifically to the 17 states included in our review. See appendix II for a

⁵Market share information represents a percentage of total net written premium (over \$664 billion nationally) for all types of insurance. It represents the percentage of nationwide sales accounted for by all companies domiciled in a state. This information, based on 1997 financial data, was provided by NAIC.

list of the states we visited and their respective domiciled insurers' market shares.

To compare Year 2000 oversight of the insurance, banking, and securities industries, we reviewed relevant documentation from their respective financial regulators, including industry guidance on Year 2000 readiness, related correspondence directed to financial institutions, audit programs for conducting Year 2000 examinations, and proposed rules covering Year 2000 issues. We also used information gathered and knowledge developed by our other teams that had conducted reviews of the Year 2000 preparedness of the banking and securities industries. Finally, we obtained updates on the status of various Year 2000 oversight activities, including conducting examinations that focus specifically on Year 2000 issues (referred to as Year 2000 targeted examinations) and monitoring companies' actions to test their systems' readiness.

To determine the status of the insurance industry's Year 2000 readiness, we interviewed regulatory officials who were responsible for Year 2000 oversight in the 17 states and reviewed available documentation on the readiness of the industry. To obtain additional insights regarding the readiness of the insurance industry, we interviewed representatives of key rating companies, including A.M. Best Company, Conning and Company, Standard and Poor's, and Weiss Ratings, Inc., and reviewed their pertinent studies and reports issued in the area. We also spoke with representatives of and reviewed Year 2000-related documents from a few consulting and research firms, including the Gartner Group, which is a business and technology advisory company that conducts research on the global state of Year 2000 readiness, and Electronic Data Systems (EDS), which is a professional services firm that, among other things, assists financial services companies with becoming ready for 2000.

To obtain industry perspectives regarding Year 2000 issues, particularly those involving potential liability exposures, we spoke with several of the largest property-casualty insurers and trade associations, including the Alliance of American Insurers, American Insurance Association, National Association of Independent Insurers, and National Association of Mutual Insurance Companies. Among other things, we inquired about these entities' efforts to determine the nature and scope of potential liability exposures related to 2000. Finally, we reviewed available literature on various aspects of the Year 2000 liability exposure issue, reviewed relevant federal legislative proposals, and obtained related opinions from officials of the American Bar Association's Tort and Insurance Practice Section.

We did our work in accordance with generally accepted government auditing standards between September 1998 and April 1999. We requested comments on a draft of this report from the President and other officials of NAIC. NAIC's written comments are included in appendix III and discussed near the end of this letter. We also discussed the contents of a draft of this report with officials from the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC). They provided technical comments that we have incorporated as appropriate in the report.

Regulatory Approaches Varied Widely by State, Creating Year 2000 Oversight Challenges

Regulatory approaches and the level of oversight activity directed to the insurance industry's Year 2000 readiness varied widely in the states we visited. The 17 states also differed in how they assessed and prioritized companies for regulatory attention in terms of Year 2000 readiness. Such variations raise a question about the extent to which states can rely on one another's judgments regarding the preparedness of nondomiciled companies doing business in their states. This would be especially problematic when relying on states where the level of Year 2000 oversight activity is relatively limited or the criteria for assessing readiness may be considered too lax. Variations in oversight approaches among state regulators also make it difficult to ascertain the status of the Year 2000 readiness of the insurance industry on a national level.

Year 2000 Oversight Varied Widely by State

State regulatory oversight of the insurance industry's Year 2000 readiness included several types of activities, such as surveying companies, reviewing submitted company plans, requiring progress reports, covering Year 2000 readiness during regular financial examinations, and conducting examinations that focused specifically on Year 2000 issues. Which of these activities each state insurance regulator engaged in, and to what extent, varied. The variation ranged from a few states that had actively promoted insurers' Year 2000 readiness since mid-1997 to a few states that did little in the area until the latter part of 1998 when they conducted their first surveys. A company identified as being behind at this late date could have more difficulty completing all of the necessary phases of its Year 2000 preparations in time.

Although they did not initiate Year 2000 oversight actions until 1997, after the time frame suggested in the Assessment Guide for conducting awareness efforts,⁶ 2 of the 17 states we visited were comparatively more active than the other 15 in their efforts to ensure that insurance companies become Year 2000 ready. One state regulator stated that it monitored the

⁶According to the Assessment Guide, Year 2000 awareness should have been completed during 1996.

Year 2000 progress of companies it supervises primarily through quarterly Year 2000 reports that were required since the beginning of 1998 and through targeted Year 2000 examinations that have been conducted since mid-1998. According to state officials, these efforts were conducted by state examiners who had drawn heavily from the expertise, guidance, and training of federal banking regulators.

Another state regulator also more actively monitored insurers' Year 2000 readiness, but used a different approach. In 1997, it hired a contractor to assist with developing, administering, and analyzing a comprehensive, technical survey of about 2,000 insurers (both domiciled and nondomiciled) regarding their Year 2000 preparations. State officials explained that companies were assigned risk scores that were based on an analysis of their survey responses along with various financial and operational factors. This state's regulatory staff, subsequently supplemented by an available pool of about 20 consultants, has been reviewing hundreds of remediation plans for companies identified as having problems with their Year 2000 efforts, working with these companies to develop or refine their plans, and conducting Year 2000 targeted examinations. These consultants were also to be used to assist company management in correcting system problems.

Other state regulators indicated that they focused primarily on occasional surveys or more limited coverage of Year 2000 plans during regular financial examinations, which are to be conducted every 3 to 5 years. One state regulator said it attempted to consistently inquire about Year 2000 issues during informal conferences with company management. Another state regulator indicated that it was focusing its Year 2000 oversight efforts almost exclusively on conducting surveys of its regulated companies. At the time of our review, this state had administered two Year 2000 surveys that requested companies to generally address a few broad areas, such as the estimated impact of the potential Year 2000 problem on their operations, their conversion plans, and their current status of readiness.

After experiencing some difficulty administering a survey in 1997, another state regulator said it decided, in early 1998, to conduct targeted Year 2000 examinations in lieu of administering additional surveys or covering the area during regular financial examinations. This state, however, was unable to start its targeted examinations until September 1998. Five of the 17 states we visited did not attempt to develop baseline information on the readiness of their insurance companies until the latter part of 1998, when they conducted their first Year 2000 surveys.

Because of the fast-approaching Year 2000 deadline and in an attempt to make up for lost time, some state insurance regulators were beginning to intensify their oversight efforts while there was still a possibility of mitigating possible disruptions. In addition to those state regulators that had recently conducted surveys at the time of our review, several state regulators had just contracted or were in the process of contracting for consultant services to assist with Year 2000 targeted examinations.

How States Assessed and Prioritized Companies for Year 2000 Oversight Purposes Varied

The state insurance regulators we visited attempted to prioritize companies in terms of their Year 2000 readiness and the extent of related supervisory attention that they may need. This prioritization was generally done to determine how best to allocate limited resources to the area. Responses to our survey indicated that state regulators varied in how they assessed and prioritized companies for Year 2000 purposes—that is, they used different sources of information, review criteria, and regulatory actions to handle identified high-priority insurers.

The information that state insurance regulators obtained from their diverse oversight activities can be characterized by varying degrees of credibility. For example, information obtained from an on-site targeted examination conducted by information specialists would be more credible than information obtained from unverified, self-reported insurer responses to a Year 2000 survey. At the time of our review, the state regulators said they used the following sources of information to prioritize companies in terms of their Year 2000 readiness: survey responses; Year 2000 plans; Year 2000 quarterly reports; regular financial examinations with some questions directed to Year 2000 issues; and, in one case, Year 2000 targeted examinations. Eight of the 17 states we visited (representing 24.5 percent of the total market share) indicated that they used survey responses as their primary means for prioritizing companies. Two state regulators said that they had not yet prioritized their companies for Year 2000 oversight purposes when we conducted our survey in late January 1999, but that they were waiting for additional Year 2000 information from their contractors.

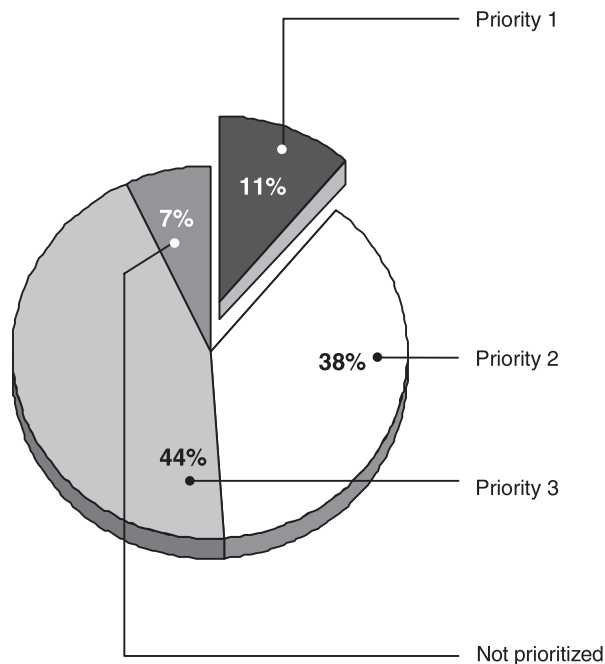
State regulators also used different criteria to assess and prioritize companies for Year 2000 oversight purposes. The most stringent criteria used by the regulators we visited to identify “priority 1”⁷ companies included those companies not expected to be compliant by January 1999. The least stringent criteria used to identify priority 1 companies included

⁷The term “priority 1” refers to companies whose Year 2000 efforts were determined by the state regulators to need a high degree of regulatory attention.

only those companies that were not expected to be Year 2000 compliant by December 1999 and that had not developed a contingency plan. Other criteria were broad and vague, such as criteria that simply described priority 1 companies as those that did not adequately address or allocate resources to Year 2000 preparations. Over half of the states surveyed indicated that priority 1 companies were those that would become compliant after June 1999 or that were still in remediation (i.e., in the process of making system changes to become Year 2000 ready) after December 1998. Some states said they identified as priority 1 companies insurers that did not respond to Year 2000 surveys or that did not have formal Year 2000 plans. A few state regulators noted that they also considered the companies' market share and overall financial condition when they prioritized companies for Year 2000 oversight purposes.

As shown in figure 1, 11 percent of the insurance companies domiciled in the states that we surveyed were identified as priority 1 companies for Year 2000 oversight purposes. Appendix IV provides a breakdown, by type, of priority 1 companies relative to total insurance companies. Appendix V provides a breakdown, by size, of priority 1 companies relative to industrywide data.

Figure 1: States' Prioritization of Companies for Year 2000 Oversight Purposes



Note 1: The number of insurance companies represented is 3,565.

Note 2: Priority 1 refers to companies whose Year 2000 efforts were determined to need a high degree of regulatory attention; priority 2 refers to companies determined to need a moderate amount of regulatory attention; and priority 3 refers to companies determined to need little or no regulatory attention.

Source: Summary of state insurance regulators' responses to GAO survey.

Most of the state regulators indicated that they were in the process of conducting targeted Year 2000 examinations for all insurers identified as priority 1 companies. Others indicated that they would require priority 1 companies to submit Year 2000 progress reports, would reassess these companies on the basis of more current information before deciding to conduct any on-site visits, or would confer with company management.

Variations Among States Create Year 2000 Oversight Challenges

Variations in the Year 2000 oversight activities of state insurance regulators raise a question about the reliability of regulatory information on the Year 2000 readiness of insurers and the validity of related assessments. For example, information obtained through on-site examinations is generally more reliable than survey information. This question of information reliability can pose a challenge for state regulators that depend on one another for supervisory information on the Year 2000 status of their nondomiciled companies. Another related challenge to state regulators involves industry concerns regarding the confidentiality of information on insurers' Year 2000 readiness. Finally, the regulators, and ultimately the public, lack a comprehensive framework for fully assessing the status of the insurance industry's Year 2000 readiness due, in part, to different oversight approaches at the state level.

Most state regulators we surveyed indicated that they were concerned about the Year 2000 readiness of nondomiciled insurance companies, especially those that do a significant amount of business in their states. The two more active states previously noted said that they were attempting to oversee their nondomiciled insurers in a manner similar to their domiciled insurers. A third state, according to an official, was asking its nondomiciled insurers to confirm whether their projected Year 2000 compliance dates were being met. Most of the remaining states we surveyed said they were relying on the oversight and due diligence of the states of domicile to ensure that their regulated insurers would be Year 2000 ready. For example, a few state regulators said they sent letters to selected state regulators to inquire about the readiness of specific insurers in which they were interested. Other regulators noted that they would depend on informal contacts with the other states, information sharing through NAIC, or the initiative of the states of domicile to alert them about

any potential Year 2000 problems involving insurers that do business in their states.

Industry concerns regarding confidentiality posed a challenge to state regulators that are dependent upon one another for supervisory information on Year 2000 readiness. During the past several months, NAIC, state regulators, and the industry have grappled with how to adequately safeguard potentially proprietary information while facilitating information sharing among regulators, which is critical to overseeing the readiness for the Year 2000 date change within the industry. In February 1999, NAIC finalized a standard form, to be used at the states' discretion, to facilitate information sharing and protect confidentiality. Although, according to NAIC, 39 states have adopted the agreement to date, it is too soon to tell how widely used and effective this form will be in promoting information sharing among the state regulators.

State Insurance Regulators Started Their Year 2000 Oversight Efforts Later Than the Banking and Securities Regulators

Insurance, banking, and securities are different industries with different regulatory structures. It may not always be appropriate to make direct comparisons between either the industries or their regulation. However, preparing for the Year 2000 date change is a problem that is common to all three industries. Similarly, the solutions to this problem—both from a business and a regulatory perspective—are also common across all three industries.

Banking, securities, and insurance regulators have all taken steps to oversee the Year 2000 preparedness of their respective regulated entities. However, state insurance regulators were less active than the other financial regulators in promoting readiness and validating information on companies' status of compliance and adequacy of efforts to achieve Year 2000 readiness. In general, insurance regulators also were less active in planning for and pursuing formal enforcement actions against companies identified as remiss in their Year 2000 efforts or in danger of not being ready for the date change.

Regulatory Approaches to Facilitate Financial Institutions' Efforts to Become Year 2000 Ready

For the institutions that they regulate, banking and securities regulators have provided guidance and direction regarding Year 2000 problems, while state insurance regulators we contacted indicated they have provided little guidance. Within the banking industry, the Federal Financial Institutions Examination Council (FFIEC),⁸ through its member agencies, has taken actions to raise the banking industry's awareness of the Year 2000 problem and provide depository institutions with Year 2000 guidance, including expectations regarding when certain phases of their conversion should be completed. Within the securities industry, SEC regulates broker-dealers, investment advisors, investment companies, transfer agents, and other securities firms. SEC has engaged in similar efforts to promote Year 2000 readiness, both through its own efforts and through the securities industry's self-regulatory organizations.⁹ But, for the most part, state insurance regulators we contacted and NAIC were not as active in this area.

Raising Industry Awareness

In our Assessment Guide,¹⁰ we stated that Year 2000 awareness efforts should have been completed during 1996. In June 1996, FFIEC began to raise industry awareness by disseminating letters to all federally supervised banking institutions on topics associated with Year 2000 readiness. Also starting in June 1996, SEC sent letters to industry trade associations, and subsequently to firms, informing them of the threat posed by Year 2000 problems and urging them to address these problems.

In contrast, individual state regulatory efforts to raise insurers' Year 2000 awareness generally did not begin in the states we visited until 1997 or, for some of the states, until late 1998. These efforts typically took the form of questionnaires to insurers inquiring about their state of preparedness. NAIC began discussing Year 2000 issues in its quarterly national meetings in early 1997. Since that time NAIC indicated that it has used its quarterly meetings as a forum for raising regulator and industry awareness and for

⁸FFIEC was established in 1979 as a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions, and to make recommendations to promote uniformity in the supervision of these institutions. The council's membership is made up of the federal bank regulators—the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Comptroller of the Currency—and the regulators for credit unions and thrift institutions—the National Credit Union Administration and the Office of Thrift Supervision, respectively.

⁹In addition to SEC oversight, broker-dealers in the United States are subject to regulation by the various exchanges and the National Association of Securities Dealers, which act as self-regulatory organizations over their securities firm members. These organizations adopt rules and conduct examinations to ensure that these rules, as well as those of SEC and the securities laws in general, are complied with by their members.

¹⁰GAO/AIMD-10.1.14.

sharing information on Year 2000 efforts. In August 1997, NAIC coordinated a national survey of insurers to prompt them, among other things, to take appropriate action to prepare for 2000. NAIC summarized the survey results in a December 1997 report.¹¹

For some of the state regulators we visited, the NAIC survey was their first regulatory communication with companies about Year 2000 issues. For unspecified reasons, 11 of the 50 states requested that NAIC not send a survey to their domestic insurers. NAIC's summary report speculated that these states might have been conducting their own survey. Because of state insurance regulators' late start, less time was available to assess fully insurers' Year 2000 preparedness and to ensure the public that insurers will continue to operate with minimal disruption into the new millenium.

Providing Guidance and Milestones

Since 1996, FFIEC has issued interagency guidance to federally regulated depository institutions on Year 2000 topics, such as testing, contingency planning, and business risk. It has also set milestones and formally notified the banking industry of dates when companies were expected to have completed critical phases of Year 2000 conversion (e.g., renovation and validation). Both guidance and milestones were provided to banking institutions as the criteria that would subsequently be used by examiners looking at year 2000 compliance.

SEC told us that it has provided some general guidance on Year 2000 problems, and that it has worked with the Securities Industry Association and some of the self-regulatory organizations to develop and issue explicit guidance to their members. In particular, the National Association of Securities Dealers issued guidance on topics such as investor concerns and testing requirements, and the association conducted workshops around the country to raise awareness and provide assistance regarding the Year 2000 problem. Moreover, similar to the banking regulators, the self-regulatory organizations established milestone dates for their respective member organizations.

In contrast, state insurance regulators we contacted, with a few exceptions, said that they had not provided insurance companies with formal guidance or regulatory expectations regarding Year 2000 readiness. Some state officials believed that their regulatory role precluded more active efforts in establishing what companies should do to prepare for Year 2000. These officials said that their role was to monitor Year 2000 progress, rather than to be directive with companies regarding Year 2000 solutions.

¹¹Year 2000 Insurance Industry Awareness, NAIC, December 8, 1997.

A few other officials noted that they lacked the expertise or resources to provide specific guidance on preparing for 2000.

In September 1998, NAIC issued guidance on insurance regulatory expectations, regarding due diligence in preparing for 2000,¹² for use by the industry as well as by state insurance regulators. Dissemination of this information to insurance companies was left to the discretion of individual states. Regulators in a few states we visited in late 1998 were still unaware that NAIC had issued the regulatory guidance.

Regulatory Verification of Institutions' Year 2000 Readiness

Financial regulators have generally focused their verification efforts on the Year 2000 readiness of their regulated institutions by (1) conducting on-site examinations and (2) requiring broadscale testing. Special on-site (targeted) examinations are to focus primarily on the actions that institutions are taking to prepare for 2000, in other words, on the process up to and including a review of test results and contingency planning. Broadscale tests are to demonstrate whether, after all of the preparations, an entire integrated segment of a financial sector could continue to operate and interact together. Broadscale testing, however, does not cover the potential impact of third-party systems (e.g., those of vendors or infrastructure industries, such as power and communications) that are in some way linked to the institutions nor does it provide information about contingency planning.

The structure of the securities industry and, to a lesser extent, of the banking industry lends itself to broadscale testing because there is a significant amount of interconnectedness among industry participants (i.e., industry interdependence that is based on extensive transactions and system links between and among companies in a particular industry). This interconnectedness is limited in the insurance industry. As a result, examinations represent the primary means for insurance regulators to verify the Year 2000 readiness of their companies.

To validate the progress and status of their regulated institutions, banking regulators rely primarily on examinations targeted directly at issues related to Year 2000 problems. The first round of such examinations began in May 1997. As of April 1999, regulators had completed their second round of targeted examinations. Bank regulators told us that every institution has now been examined twice for Year 2000 progress. This effort has provided regulators with not only snapshots of the current status of institutions but

¹²Insurance Regulatory Statement Regarding Industry Year 2000 Compliance and Remediation, approved by NAIC's Year 2000 Working Group on September 8, 1998.

also with an indication of their progress over time. Furthermore, regulators plan to return to or contact institutions where questions on the adequacy of their progress remain. Indeed, OCC plans to complete, by July 1999, a third round of on-site examinations of all institutions for which it has supervisory responsibility.

The federal banking regulators have also encouraged depository institutions to participate in broadscale testing efforts. The Federal Reserve, for example, has encouraged banks to participate in tests demonstrating their ability to successfully interface with Federal Reserve supplied services (e.g., check clearing). Also, according to an agency official, OCC has worked closely with two bank trade associations in their efforts to coordinate Year 2000 testing among participating banks. Such tests are intended to provide further assurances of the banking industry's readiness to meet Year 2000 challenges.

The interconnectedness of the securities industry lends itself to broadscale testing. With SEC's support, over 400 institutions were participating in "streetwide" testing at the time of our review. A preliminary test was conducted in July 1998, and a second round of tests began in March 1999 and was scheduled to continue through April 1999.

According to an agency official, SEC has an active examination program. For example, during 1998, SEC conducted more than 4,400 on-site reviews of fund and investment advisers, approximately 60 percent of the registered adviser community. The reviews focused on the firms' timetables for completing and testing their Year 2000 corrections. Similar reviews were conducted for selected transfer agents and broker-dealers. Firms whose timetable lagged significantly behind SEC's guidance (e.g., that all corrections be completed by December 31, 1998, reserving 1999 for testing) were given a deficiency letter regarding their delay.

In addition to SEC examinations, the self-regulatory organizations have conducted ongoing monitoring of their members through telephone contacts. However, unlike banking regulators who said they had conducted examinations of every institution, SEC and the self-regulatory organizations have not examined and do not plan to examine every regulated entity. They are relying on the disclosures mandated by SEC and broadscale tests, as well as targeted examinations, to provide assurances of the readiness of other institutions.

State regulators' efforts to validate the Year 2000 readiness of insurance companies began later than those of the banking and securities regulators.

In most states, such efforts have also lacked the vigor demonstrated by banking and securities regulators. In December 1997, NAIC approved the addition of nine questions on Year 2000 preparations to the Financial Examiners Handbook, which is the required audit guide used by insurance examiners in all states. Most states we contacted said they began coverage of their regulated insurance companies during regularly scheduled financial examinations starting in early 1998. However, state insurance regulators require routine financial examinations once every 3 to 5 years. By the beginning of 2000, many companies' last regular examination would not have included questions on Year 2000 preparedness. Recognizing this Year 2000 oversight limitation, some state regulators said they have begun or are considering incorporating targeted Year 2000 examinations into their validation programs. One state said it began conducting such examinations in mid-1998. Several more state regulators said they began targeted examinations late in 1998, and others indicated they had either just begun or plan to begin targeted examinations during 1999. Three other states we visited were uncertain as to whether targeted examinations were needed. Representatives of 4 of the 17 state insurance departments we visited told us that they did not plan to conduct targeted examinations. Eight states that were conducting or planning to conduct targeted examinations had no plans to examine all domiciled institutions. Instead, they said their goal was to examine only companies believed to pose the greatest risk. In general, limiting on-site regulatory examination efforts pertaining to Year 2000 readiness would provide correspondingly limited assurances that survey information self-reported by insurers was reliable, especially when these efforts were not supplemented by any other type of validation.

Regulatory Enforcement of Year 2000 Readiness

State insurance regulators have generally been less active than the other financial regulators in planning for (e.g., establishing clear expectations that insurers can be held accountable for meeting) and pursuing formal enforcement actions against companies that are not responsive to regulatory requirements regarding the Year 2000 date change. Two circumstances, in particular, that may warrant enforcement attention involve insurers' (1) lack of responsiveness to requests for Year 2000-related information and (2) insufficient actions to prepare for 2000. Most of the state regulators we visited had addressed identified problems related to obtaining Year 2000 information from insurers. However, without having established clear regulatory expectations for their companies, insurance regulators were less prepared than the banking and securities regulators to deal with potential readiness issues.

While the banking regulators used on-site examinations as a primary means of obtaining and reviewing Year 2000-related information, most of the insurance regulators we visited used surveys, which were usually administered under their examination or regulatory access authority, as a key source of insurer information.¹³ State officials explained that administering surveys under their examination authority provided them with a greater assurance that they would receive high response rates and with additional leverage to take action if an insurer did not provide requested Year 2000 information.

In addition to conducting examinations, SEC required the entities it oversees to provide reports on their Year 2000 efforts and progress. Because SEC issued specific reporting requirements and related guidance, it has been able to take action against companies that failed to comply. For example, at the time of our review SEC had undertaken formal proceedings, involving fines of up to \$25,000, against 46 companies for failure to file these required Year 2000 reports in a timely manner.

Regarding Year 2000 readiness issues, the banking regulators have taken measures to ensure that they are prepared to pursue enforcement actions against companies identified as not adequately preparing to become Year 2000 compliant. As previously mentioned, banking regulators have set milestones and formally notified banking institutions about when they were expected to have completed certain phases of Year 2000 conversion. Banking regulators have also developed a uniform examination rating system for Year 2000 readiness that they used to help identify when regulatory intervention was warranted. In addition, the banking regulators have included enforcement actions in their Year 2000 supervision program to prompt remedial action by financial institutions that are not making adequate progress. Using these mechanisms, the banking regulators were able to initiate formal actions against some institutions, as early as November 1997, for failing to make adequate progress toward becoming Year 2000 ready.

SEC recently proposed actions that may be taken if securities market participants are not deemed to be ready for 2000. In March 1999, SEC released for comment a proposed rule that would require broker-dealers and transfer agents to complete certain actions (e.g., verify remediation efforts through internal testing) to become Year 2000 ready by no later

¹³According to state officials, a regulatory survey administered under examination authority places the surveyed companies under the same legal obligation to provide true and complete information as they would be under if examiners were physically present in the company.

than August 1999. According to the proposal, if a broker-dealer cannot ready its systems by October 15, 1999, it would be required to cease conducting securities activities with customers and to transfer its existing customer accounts to another firm.

The state insurance regulators tended to be less prepared than the other regulators to institute enforcement actions against companies that were identified to be at a high risk of not being Year 2000 ready. With a few exceptions, the states we visited had not provided insurance companies with specific regulatory expectations (e.g., deadlines for selected phases of Year 2000 readiness) that could be used as a basis for determining when regulatory actions should be taken. According to an NAIC survey of all states,¹⁴ two states had a formal plan that included specific triggers for determining when a regulatory action should be taken against a company, and a few additional states were in the process of developing such a mechanism.

The majority of state regulators indicated that some form of intervention could occur if a company's activities posed a threat to its continued operations or financial solvency. However, some state regulators held divergent views on the fundamental question of whether they had the statutory authority to take action against a company, prior to 2000, for not being prepared for the date change. At the time of our review, 1 of 17 state insurance regulators informed us about a Year 2000-related regulatory intervention involving a company that did not have a remediation plan.

Information on the Year 2000 Readiness of the Insurance Industry Has Limitations, but the Industry Is Viewed as Generally on Track

Regulatory information on the Year 2000 readiness of the nation's insurance industry does not provide the necessary information to judge whether the industry will be ready for 2000. Although the state insurance regulators we visited have relied primarily on unverified company responses to Year 2000 surveys, the regulators are generally confident about the ability of the industry to become Year 2000 ready. They said that most insurers, particularly the larger ones that are strongly influenced by competitive market forces, are well under way in their efforts to become Year 2000 ready. Other nonregulatory sources are similarly optimistic about the insurance industry's Year 2000 readiness relative to the readiness of other U.S. industries. These other sources include rating companies that have reported that the insurance industry appears to be generally on track to Year 2000 readiness. These views should be viewed with some caution, however, because many of these observations are

¹⁴Survey results are summarized in Year 2000 Industry Compliance Status; NAIC; Year 2000 Working Group; Report to Commissioners; December 6, 1998.

based primarily on information that has been self-reported by the insurance companies and that, for the most part, has not been validated.

Regulatory Information on Industrywide Year 2000 Readiness Is Limited

Quarterly Year 2000 industry compliance status reports, which NAIC prepares for the state insurance commissioners, represent the only industrywide regulatory information in the area. To date, NAIC has issued two such reports. These reports, intended to convey information on insurance company readiness as reported by the state regulators, provide insights on regulatory efforts and industry readiness at the state level. They do not, however, provide an effective gauge for the status of the industry as a whole. Information in these reports comes from different sources and represents different points of time, making it methodologically inappropriate to link the information together as a basis for determining the overall industry's Year 2000 readiness.

The latest industry status report, for example, attempts to provide Year 2000 readiness information for insurance companies in each state. The report presents information from 30 states on the basis of surveys conducted at various periods between July 1997 and December 1998. Compliance information for the remaining 20 states was taken from an outdated industrywide survey that NAIC conducted between August and October, 1997. In both cases, information on Year 2000 compliance represented company responses to surveys that, with a few exceptions, had not been verified.

State Regulatory Officials Are Generally Confident in the Insurance Industry's Ability to Be Year 2000 Ready

State regulatory officials we interviewed did not identify any major concerns related to the Year 2000 readiness of the insurance industry in their respective states. In general, they were confident that the industry has been actively preparing for 2000 and would, for the most part, be ready for the date change. Officials explained that the insurance industry is a transaction-driven business that is highly dependent on date-sensitive information and processing. Thus, the Year 2000 issue is not a new one for insurers, especially for the larger, more sophisticated companies that recognize the potential impact it may have on their business continuity and financial stability. Officials believed that, assuming they have obtained the requisite commitment from senior management, most large insurers have allocated sizable resources to and are well under way in their conversion efforts.

State officials stated that, in general, the small and medium-sized insurers do not have the same level of appreciation or understanding of the Year 2000 problem as the larger companies. They indicated, however, that they were not significantly concerned. NAIC's December 1997 report suggests

this “lesser understanding” of the issue could stem from the fact that many of the smaller insurers do not have complicated, internally developed computer systems. To the extent that smaller insurers use vendor software, and to the extent that software is compliant, these insurers will generally have an easier time with their conversion efforts. Some state officials also added that, for smaller insurers, a reasonable and relatively easy way to implement a contingency plan would be to revert to a manual system on a temporary basis.

State officials noted that they were generally unconcerned that Year 2000-related problems involving individual insurers would result in systemic disruptions to the industry as a whole. A few officials explained that unaffiliated insurance companies generally maintained stand-alone systems, and that the failure of an individual insurer would have limited effects on other insurers outside of those with which it may be jointly owned. Some officials expressed greater concerns regarding, for example, specific segments of the health insurance industry that may be linked to systems associated with government programs, such as Medicare.

Regulatory responses to our inquiry regarding the number of individual insurers that may not be Year 2000 ready were generally consistent with states’ expressed optimism regarding the industry. In our January survey of 17 state regulators, we asked the following question: “Based on your knowledge to date, how many domiciled insurance companies does your state consider to be at a high risk of not being Year 2000 ready?” Five states were confident that none of their domiciled insurers were at a high risk of not being Year 2000 ready. These five states, however, used the less stringent criteria for assessing readiness (e.g., companies not expected to be compliant by December 1999 and without a contingency plan) or relied almost exclusively on survey information as the basis of their assessments. Seven states attempted to estimate the number of insurers thought to be at a high risk of not being ready. The proportion of high-risk companies to the overall number of companies ranged from 4 to 25 percent, with the average being 10 percent. Over 80 percent of these companies perceived to be high risk were categorized as small companies that write policies representing less than \$100 million in net premiums. The remaining five states did not respond to the question; a few states noted that additional information was needed.

Other Sources Are Similarly Confident and Have Not Identified Any Major or Systemic Problems Related to the Insurance Industry's Year 2000 Readiness

Independent sources, such as consulting firms and rating companies, have not identified any major or systemic problems relative to the Year 2000 readiness of the insurance industry. Although their observations are based almost exclusively on information self-reported by insurers, these sources, like the state regulators, are generally confident in the ability of the insurance industry to be Year 2000 ready.

The Gartner Group, for example, has stated that the financial services industries, including the insurance industry, lead all other industries in efforts to become Year 2000 ready.¹⁵ It explained that the insurance industry began having data failures over 10 years ago when, for example, it was required to calculate future payments on 10- or 15-year annuities. Because of such time-driven products and because of the critical impact that information technology systems have on insurers' business operations, a Gartner Group official indicated that insurers began their compliance efforts early and have since been able to make great strides in the area. The Gartner Group's research regarding Year 2000 information was largely gathered from interviews and client inquiry meetings covering 27 industries and an estimated 15,000 companies in 87 countries.

Key rating companies have not identified any major or systemic problems pertaining to the Year 2000 readiness efforts of the insurance industry, and these companies have, in fact, provided positive critiques of industry efforts in the area. A.M. Best Company, in a February 1999 report, concluded that although most insurers were still in the remediation and testing phases of addressing their Year 2000 readiness efforts, all but a few insurers will be fully operational in January 2000.¹⁶ The company based this conclusion on a Year 2000 survey of 1,709 insurance entities that was conducted in November 1998. According to the report, although only 45 percent of the companies responded to the survey, these companies represented nearly three-quarters of the industry volume.

Weiss Ratings, Inc., also addressed the insurance industry's preparedness in a September 1998 report.¹⁷ On the basis of a survey of 5,096 insurers that resulted in a 22-percent response rate, Weiss Ratings, Inc., reported that 93 percent of the survey respondents indicated they have progressed

¹⁵Year 2000 Global State of Readiness and Risks to the General Business Community and Year 2000 International State of Readiness, Gartner Group testimony before the U.S. Senate Special Committee on the Year 2000 Technology Problem, October 7, 1998, and March 5, 1999, respectively.

¹⁶Seeking Y2K Compliance: A.M. Best's Insurer Readiness Report, A.M. Best Company, Inc., February 1999.

¹⁷The Weiss Y2K Ratings of Insurance Companies, Weiss Ratings, Inc., Fall 1998.

adequately in their efforts to become Year 2000 ready. Conning and Company also observed that the insurance industry is making good progress in its internal systems efforts for Year 2000 compliance. Standard and Poor's noted that Year 2000 system issues for most insurers are approaching a resolution and that, as of March 1999, no insurance company rating was downgraded because of Year 2000 problems.

Although independent sources have reported that insurers were generally doing well with their internal efforts to become Year 2000 ready, some have also suggested that insurers may face substantial threats from other related sources. Such sources include the Year 2000 compliance problems of external parties with which they do business (e.g., suppliers and government entities) or potential liability exposures arising from Year 2000 problems.

Some Insurers Face Potentially Large Year 2000 Liability Costs; Effects of Related Mitigation Efforts Are Uncertain

Within the insurance industry, major concerns and preparations related to the Year 2000 date change are not limited to readiness issues, but also include liability exposure issues. Currently, the magnitude of insurers' liability exposures cannot be estimated primarily because a claims history for the event does not exist and answers to key legal issues related to 2000 are unresolved. While not estimable, Year 2000-related liability exposures could be significant for some insurers, particularly those insurers concentrated in commercial property-casualty market sectors. Insurers' efforts to reduce these potential exposures include writing exclusionary clauses in insurance policies, performing more stringent underwriting, and educating policyholders to properly prepare their systems and operations for 2000. The effectiveness of these efforts, however, remains uncertain because insurers face various potential marketplace and legal challenges. Uncertainties also remain over the outcomes of several state and federal legislative initiatives that were recently undertaken to address Year 2000 liability exposure issues.

Year 2000-Related Liability Exposures and Legal Costs Are Not Yet Estimable but May Be Significant for Some Insurers

Industry professionals and observers acknowledge that the magnitude of Year 2000-related exposures cannot be estimated at this time. They also indicated that property-casualty insurers, particularly those that write a significant amount of commercial insurance (e.g., policies for directors and officers, errors and omissions, commercial general liability, and business interruptions), are more vulnerable to Year 2000-related liability exposures than are other types of insurers. Moreover, lawyers and industry professionals have said that insurers may face significant legal costs to resolve Year 2000-related claims and lawsuits.

Because of the uniqueness of the Year 2000 event, the potential magnitude and scope of impacts caused by related computer malfunctions are largely unknown. Insurers have little to rely upon in estimating their potential exposures since there is no claims history for such an event and many key legal issues related to coverage and the interpretation of various types of insurance policies are unresolved. Among the many coverage-related issues that may be raised by insurers to limit coverage are those involving “fortuity” and “triggers.”

Insurance coverage generally applies to losses caused by “fortuitous events,” that is, events that are unexpected, unusual, and unforeseen. Insurers have generally asserted that because the Year 2000 problem is widely known and timely remedial measures in many cases have been available, Year 2000-related losses sustained by computer users are not fortuitous and therefore would not be covered by some types of policies (e.g., business interruption insurance). Conversely, those seeking coverage for losses are expected to argue that specific Year 2000-related mishaps and their associated losses were unforeseen despite reasonable efforts to prepare for the event, or their losses were so unusual that they were not to be expected.

Insurance coverage also depends on what event “triggers” coverage. Under some types of policies, coverage would depend on the point in time that the covered event occurred. For instance, in disputes concerning computer users, sellers, servicers, and manufacturers, there may be questions as to whether the event causing Year 2000-related damages occurred when a system was manufactured or distributed, a system was installed, a Year 2000-related problem was noticed, or damages were incurred. If disputes over insurance coverage are based on trigger issues, the courts may have to decide when coverage was activated for a particular policy. Until these and other questions are addressed in the context of the Year 2000 event, insurers will continue to have difficulties estimating related liabilities.

Estimating the magnitude of insurers’ exposures due to the Year 2000 event is also difficult because of the variety of issues and litigants that could be involved in potential lawsuits. As Year 2000 disputes emerge, insurance coverage issues will surface as plaintiffs and defendants alike try to recoup alleged losses from insurers. Insurance industry observers frequently categorize anticipated Year 2000-related lawsuits into three “waves” of litigation over: (1) costs to become Year 2000 compliant, (2) losses resulting from Year 2000 problems, and (3) coverage for Year 2000-related losses. Many lawsuits involving disputes over the responsibility for costs to upgrade systems for 2000 have already been filed (e.g., disputes

between vendors and users to remediate software in noncompliant systems).

Several legal experts predict another wave of lawsuits associated with actual losses caused by Year 2000 mishaps, such as those seeking compensation for losses arising from the alleged failure of a firm and/or its officers to adequately prepare for and disclose Year 2000 problems. Insurers may be responsible for paying claims on damages incurred by policyholders if coverage is established. In addition, industry representatives and legal experts agree that lawsuits between insurers and policyholders could result from insurers denying coverage.

Further complicating the ability of insurers to estimate their exposures for the Year 2000 event are the potential legal costs, including those arising in connection with insurers' general duty to defend policyholders against liability suits. Insurers expect to incur significant legal costs to defend their general liability policyholders against third-party lawsuits, even when coverage may be questionable. Many industry representatives and observers have indicated that legal costs could exceed claims costs associated with Year 2000 problems.

Since insurers are unable to estimate their potential Year 2000-related liabilities, they are also unable to reflect appropriately all of their potential liabilities by modifying their reserve posture. Generally speaking, reserves cannot be reasonably established until the liabilities are both probable and reasonably estimable. Year 2000-related liabilities continue to be inestimable in the insurance industry.

Insurer Efforts to Mitigate Potential Year 2000 Liability Exposures Face Challenges

In light of the uncertain but potentially significant Year 2000-related liability exposures, many insurers have taken steps to limit or reduce their exposures. These measures include the insertion of exclusions into certain types of policies, more stringent underwriting practices, and educational programs to encourage policyholders to properly prepare themselves for 2000. The effectiveness of insurers' efforts to mitigate their exposures remains unclear as some mitigation measures face legal and marketplace challenges.

Many insurers, particularly those writing commercial general liability policies, are attempting to limit their exposures by incorporating exclusions into their policies. The state insurance regulators have generally approved of some form of Year 2000-related exclusions developed by the Insurance Services Office for commercial lines of

insurance.¹⁸ However, although exclusions are intended to limit coverage for Year 2000-related mishaps, uncertainties remain as to the effectiveness of such practices.

According to legal experts, the courts may be asked to decide whether Year 2000 coverage exclusions are legitimate. Some experts have expressed uncertainty over whether courts will uphold the Year 2000 exclusions due to public policy concerns. Moreover, where such exclusions are upheld, specific coverage questions could remain as courts typically interpret exclusions narrowly. Some insurance and legal professionals also have said that the use of an exclusion could be viewed as evidence that a standard policy without the exclusion was intended to cover losses from a Year 2000 failure. To avoid this risk, some insurers have opted not to use exclusions, emphasizing that their policies have never covered direct Year 2000 losses. Nevertheless, insurance professionals explained that standard policies may cover losses arising in connection with a Year 2000-related mishap that causes an insured event resulting in a loss, such as a fire or an auto accident, irrespective of whether the incident was caused by a Year 2000 glitch. For instance, a standard automobile policy may not cover expenses to fix a car that failed because of a Year 2000 problem, but the policy could cover damages for an accident caused by a Year 2000-related vehicle malfunction.

Some insurers are also attempting to mitigate their liability exposures through more stringent underwriting practices and educational programs that encourage policyholders to prepare their operations and contingency plans for the Year 2000 event. Assessing their policyholders' Year 2000 preparation efforts, writing policies that reflect each policyholder's Year 2000-related risks, and sending policyholders guidance materials to emphasize the importance of Year 2000 preparation efforts are other techniques used by some insurers to mitigate their potential liabilities. Such loss control efforts are aimed at reducing the insurers' potential exposures due to Year 2000-related coverage claims and lawsuits.

The extent to which mitigation measures can be effectively employed also depends on the competitive marketplace and the individual business relationship insurers have with their policyholders. Industry professionals

¹⁸The Insurance Services Office is an organization that assists property-casualty insurers by collecting and generating data on the loss experience of the industry as a whole. This organization also prepares generalized policy forms to be used by insurers at their discretion. For example, one Year 2000 exclusion form developed for liability policies excludes liability damages associated with computer system-related failures "due to the inability to correctly recognize, process, distinguish, interpret, or accept the year 2000 and beyond."

and observers indicated that some policies covering Year 2000-related damages may still be available and acknowledged that the use of exclusions was not always practical in the marketplace. For instance, one commercial property-casualty insurer indicated the company had lost accounts to another insurer that was willing to offer insurance without a Year 2000 exclusion.

Effects of Regulatory and Legislative Efforts Are Uncertain

We observed in the states we visited that state regulatory efforts to help companies address and mitigate their potential liability exposures have generally focused on the consideration and approval of exclusionary forms that some companies want to place on their policies. These states have generally approved the standard exclusionary endorsements proposed by the Insurance Services Office, or similarly worded forms, that identify coverage exclusions for Year 2000-related losses. A spokesperson for the Insurance Services Office indicated that all of the states had approved of certain exclusions for commercial lines of insurance. Beyond these exclusionary approvals, we found that the regulatory efforts of the states we visited to address companies' potential liability exposure problems have generally been limited. Some state regulators included questions related to Year 2000 liability exposures in the surveys that they sent companies to help raise awareness about the issue. Most of the regulators we visited did not indicate any specific efforts to identify potential liability exposure issues among their regulated companies.

Other uncertainties remain over how several state and federal legislative initiatives will affect insurers' potential Year 2000-related liability exposures. Legislative actions to address the resolution of Year 2000-related disputes, thus far, have consisted primarily of sovereign immunity laws passed by several states to protect themselves from Year 2000-related lawsuits. Many other state and federal legislative initiatives are currently being considered, some of which propose alternative dispute resolution methods to help resolve disputes involving Year 2000-related mishaps. A number of pending legislative initiatives also seek to limit Year 2000-related liabilities in a variety of ways. Among other things, proposed measures include special rules for liability standards and class action lawsuits, liability caps, prohibitions on punitive damage awards, and waiting periods to give potential defendants an opportunity to remedy noncompliant systems before lawsuits can be filed. Uncertainties continue as numerous legislative initiatives addressing resolution methods and damage awards for Year 2000-related disputes are still being debated.

Conclusions

Generally, state insurance regulators' responses to the Year 2000 challenge started late and, with a few exceptions, were limited in scope. Also, the level of regulatory activity to promote and assess insurance companies' Year 2000 readiness and to validate self-reported information on readiness varied widely by state. As a result, it is sometimes difficult, both for other regulators and for the public, to know how much confidence they can have that specific insurers or the overall insurance industry will be able to continue operations with minimal disruptions into the new millennium.

Generally, insurance regulators have not been as active in encouraging, validating, and enforcing Year 2000 preparation efforts as the banking and securities regulators. NAIC, which assumed the role of facilitator of state regulators' Year 2000 oversight efforts, has also been late in many of its actions. Among those actions were NAIC's August 1997 survey, which was its first attempt to formally notify insurance companies about the Year 2000 problem and to encourage state regulators to take action. Similar actions were taken by banking and securities regulators beginning in 1996. Furthermore, NAIC did not incorporate Year 2000 questions into the Financial Examiners Handbook until prior to examinations done in 1998, despite a normal examination cycle in the states of 3 to 5 years for insurance companies. NAIC also did not issue Year 2000 guidance, including recommended regulatory and industry expectations, until September 1998. At that time, the guidance was disseminated to the state regulators but not necessarily to all insurance companies. Finally, state insurance regulators were generally less prepared than the other financial regulators to pursue formal enforcement actions against identified problem companies due, in part, to the lack of clearly established and well-communicated expectations (e.g., milestone dates for specific phases of the Year 2000 conversion) for insurers.

State regulators and industry observers report that the insurance industry is in reasonably good condition with respect to Year 2000 readiness. However, this assertion is based primarily on self-reported information that has not yet been verified. Furthermore, the state regulatory data available through NAIC do not provide an effective gauge to assess the status of the industry as a whole because of large differences in the dates that information was collected by the states. Moreover, these data on industry compliance were based almost exclusively on survey responses.

At present, the magnitude of costs associated with claims and legal defenses for Year 2000-related mishaps is not yet estimable but has the potential to be substantial for some property-casualty insurers. Although many insurers have taken actions to reduce their potential liability

exposures, the effectiveness of these mitigation efforts remains uncertain. Ultimately, insurers' Year 2000-related liability exposures will depend on decisions made to resolve key legal questions and numerous pending legislative initiatives. Until then, insurers will continue to face challenges in estimating their Year 2000-related liabilities and modifying their reserve posture, as warranted.

NAIC Comments and Our Evaluation

NAIC provided written comments on a draft of this report. A reprint of NAIC's letter can be found in appendix III.

NAIC stated that its members have been proactively addressing Year 2000 issues since 1997, and it provided a Year 2000 chronology of NAIC activities. However, based on the suggested milestones in our Assessment Guide, as well as our comparison of insurance regulators to other financial regulators, we continue to believe that regulatory efforts to oversee the insurance industry's Year 2000 readiness began late and have generally been limited. Specifically, the state insurance regulators we visited were less active in their efforts to promote Year 2000 readiness and efforts to validate information on the status of companies' readiness. They were also less active in planning for and pursuing formal enforcement actions against companies identified as inadequately preparing for Year 2000 and at a high risk of not being ready for the millenium change. In addition, NAIC was generally late in providing information and guidance to state regulators about the appropriate Year 2000 regulatory activities to undertake. Our concern is that, given the time-consuming process of becoming Year 2000 ready, any company identified by regulators at this late date as being behind could have difficulty completing all of the necessary phases of its Year 2000 preparations in time.

NAIC also stated that much of the data used to develop the draft report was out of date, citing, for example, NAIC's recent initiative to coordinate a focused review of nationally significant companies. As discussed in the scope and methodology of this report, our noted observations are based on actions taken by state insurance regulators through January 1999. As the Year 2000 deadline approaches, NAIC's most recent initiatives, such as the focused review of nationally significant companies, may offer a practical approach to ensuring the readiness of the nation's largest insurance companies. NAIC projected that the first phase of this initiative will be completed by mid-May, with preliminary results to follow. We plan to address the results of this initiative as well as other NAIC and state regulatory actions when we provide you with updated information on the insurance industry's Year 2000 readiness as requested in your March 11, 1999, letter.

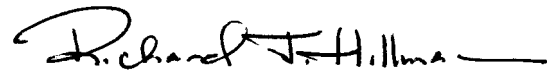
In addition, NAIC noted that our draft report reflected dates when policies were adopted by NAIC, but did not recognize the many meetings and discussions among regulators, industry, and trade associations that led to the adoption of a policy. In this report, we acknowledged that preliminary meetings to discuss and develop policies provided a mechanism among regulators and the companies involved for raising awareness and promoting a dialogue about important issues, such as preparing for 2000. However, we focused on the date that a policy was formally adopted by NAIC, rather than on the beginning of discussion. Formal adoption of a policy is a more relevant date because it signifies when agreement is reached and actions are expected to commence.

Finally, NAIC acknowledged that the state insurance regulators have developed different approaches to addressing Year 2000 problems, but NAIC viewed these oversight variations to be a significant advantage for state regulators. In our view, variation in the regulatory oversight of Year 2000 preparations across states is a concern because of the high degree of interdependency required by the state-by-state regulatory system. We found that state regulators depend on each other for the regulation of nondomiciled companies. In fact, in May 1998, NAIC recommended "...that states concentrate their evaluation efforts on domestic insurance entities." We also found that the level of Year 2000 oversight is substantially weaker in some states than in other states. In our view, this raises questions about the extent to which states can rely on other states regarding the preparedness of nondomiciled insurance companies doing business in their states. Moreover, variations in oversight approaches among state regulators also made it difficult to ascertain the overall status of the insurance industry's Year 2000 preparedness.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time we will provide copies to Representative Thomas Bliley, Chairman, House Committee on Commerce, and Senator Robert Bennett, Chairman, and Senator Christopher Dodd, Vice Chairman, Senate Special Committee on the Year 2000 Technology Problem. We will also provide copies of this report to other interested parties and will make copies available to others on request.

Major contributors to this report are listed in appendix VI. Please call me on (202) 512-8678 if you or your staff have any questions.

Sincerely yours,

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman
Associate Director, Financial Institutions
and Markets Issues

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Abbreviations

EDS	Electronic Data Systems
FFIEC	Federal Financial Institutions Examination Council
NAIC	National Association of Insurance Commissioners
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
OMB	Office of Management and Budget

Phases of Year 2000 Preparation

Table I.1: Description of Key Phases of Year 2000 Preparation

Key phases	Description of activities conducted
Awareness	Define the Year 2000 problem and gain executive level support and sponsorship. Establish Year 2000 program team and develop an overall strategy. Ensure that everyone in the organization is fully aware of the issue.
Assessment	Assess the Year 2000 impact on the enterprise. Identify core business areas and processes, inventory and analyze systems supporting the core business areas, and prioritize their conversion or replacement. Develop contingency plans to handle data exchange issues, lack of data, and bad data. Identify and secure the necessary resources.
Renovation	Convert, replace, or eliminate selected platforms, applications, databases, and utilities. Modify interfaces.
Validation	Test, verify, and validate converted or replaced platforms, applications, databases, and utilities. Test the performance, functionality, and integration of converted or replaced platforms, applications, databases, utilities, and interfaces in an operational environment.
Implementation	Implement converted or replaced platforms, applications, databases, utilities, and interfaces. Implement data-exchange contingency plans, if necessary.

Source: Year 2000 Computing Crisis: An Assessment Guide (GAO/AIMD-10.1.14, Sept. 1997).

States Visited and Market Share of Their Domiciliary Insurance Companies

We conducted site visits of 17 state insurance departments whose domiciliary insurance companies collectively accounted for 75 percent of insurance sold nationally. This included the top 12 states, each having domiciled companies with a combined market share of more than 3.0 percent, plus 5 states with relatively smaller market shares ranging from 0.3 to 2.6 percent.

Table II.1: States We Visited and Market Share of Their Domiciliary Insurance Companies

States	Percentage of total market share
Illinois	14.3
New York	11.2
Connecticut	6.5
Pennsylvania	5.1
California	4.3
Wisconsin	4.3
Texas	4.2
Ohio	4.0
Massachusetts	3.9
New Jersey	3.8
Michigan	3.5
Delaware	3.4
Indiana	2.6
Iowa	2.0
Arizona	1.0
Oregon	0.9
Utah	0.3
Total market share	75.3

Note: Market share information of each state's domiciliary insurance companies represents the percentage of net premium volume written nationwide (over \$664 billion) for all types of insurance. A domiciliary insurance company is one incorporated under the laws of the state in which it is doing business.

Source: Extracted from information provided by NAIC, based on its 1997 financial database.

Comments From the National Association of Insurance Commissioners



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April 21, 1999

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Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the advance copy of the GAO's draft report entitled *INSURANCE INDUSTRY: Year 2000 Readiness*. We appreciate the opportunity to comment on the findings in the report and inform you of the additional efforts of the NAIC and its members.

We have several initial observations about the report:

- The members of the NAIC have been proactively addressing Y2K issues using a variety of methods since 1997. These activities are documented in the attached Year 2000 Chronology.
- Much of the data used to develop the report is now out of date. The NAIC has engaged in several important initiatives in late 1998 and early 1999 to validate industry readiness.
- The NAIC is coordinating a focused review of over 1,400 nationally significant companies to determine the status of the validation that has occurred and to prioritize those companies that are in need of immediate further review.
- In addition, we view the fact that states have developed different approaches to addressing the Year 2000 problem is a significant advantage for state regulators. Because states have developed differing approaches and because their efforts often overlap, these different methods can often identify issues more quickly than a single approach would alone. The remainder of this letter will focus on additional efforts not directly addressed in the chronology that we hope you will keep in mind as your agency continues its review of Year 2000 readiness of the insurance industry.

NAIC Process

First it is important to recognize how the NAIC process works as a conduit for disseminating information to the industry. Many of the dates referenced in your report and in the attached chronology reflect when a policy was adopted by the NAIC. What is not apparent in that analysis is that leading up to the adoption, there were many earlier meetings and discussions among

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regulators, industry and their trade associations. The NAIC process has ensured that appropriate Year 2000 guidance was disseminated to the approximately 2,000 regular attendees of NAIC meetings, including the industry at large and their trade associations, earlier than reflected in your report.

Year 2000 Moratorium

One of the significant NAIC actions not addressed in your report was the Year 2000 Moratorium. This statement encouraged a minimum of insurance regulatory changes that would impact insurance company system resources to allow the insurance industry to focus those resources on Year 2000 assessment and remediation plans. We believe that the moratorium is unique among financial regulators and will contribute to the high level of readiness of the insurance industry.

Information Sharing Agreement

As noted above, the NAIC meetings provide a forum allowing our members to share information about the companies they regulate. Additionally, the NAIC Accreditation Program requires that states have statutes and policies in place to share confidential information with fellow state regulators. Finally, because sharing of specific Year 2000 examination data was needed, the NAIC began an effort to draft a Year 2000 specific information sharing agreement last December. This agreement was finalized in February 1999, and 39 states have adopted it to date.

Comprehensive Examination Program and Examiner Training

The NAIC has developed a comprehensive audit program to assist states in assessing their domestic companies Year 2000 readiness. This program was adopted in March and will be supplemented with three training programs designed to educate examiners in how to effectively conduct on-site reviews of insurers. The exam program and training have been designed to be insurance specific, and will supplement the ongoing examination efforts performed by consultants and by state examiners who currently use FFIEC and GAO guidance.

National Prioritization Effort and Funding Assistance for States

State insurance departments, working through the NAIC, have initiated an extensive process to develop a more accurate reading of the readiness of insurance companies operating on a national scale. The process entails each state providing the NAIC with specific information on efforts to assess the readiness of nationally significant companies domiciled in their state. This information, along with other information and data on these companies (e.g., Management Discussion and Analysis letters, key operating ratios, lines of business and liability exposure, etc.) will be used to prioritize insurers for additional follow-up and review by an NAIC executive task force. In this regard, the NAIC has appropriated substantial funds to use for insurers at risk of Year 2000 related disruptions or failures. The initial phase of this process will be completed by mid-May, with preliminary results to follow.

Year 2000 Liability Exposures and Mitigation Efforts

The potential exposure of insurance companies to Year 2000 claims is unique to the insurance industry and is a very important issue. Unfortunately, and as noted in your report the probability and extent of this exposure is very difficult to estimate. The NAIC members have initially addressed this issue by approving limited exclusionary endorsements to policy forms that

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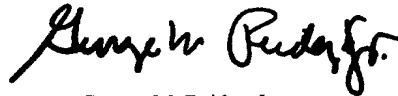
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indicated Year 2000 exposures are not covered under existing policies. Generally these exclusions are based on concepts documented in your reports such as fortuity and coverage trigger.

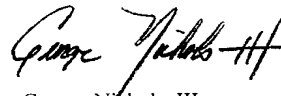
Because coverage of Year 2000 exposures may have a significant impact on insurers, the NAIC and the states have included this factor in their prioritization of companies for on-site reviews. In addition, state regulators and the NAIC are carefully watching as case law develops regarding the potential exposure to the insurance industry. These issues are regularly discussed at our National Meetings in such forums as the Property Casualty Insurance Committee, NAIC/Industry Liaison Committee, state attorneys' meeting and Chief Examiners forum.

Again, thank you for this opportunity to comment on the findings in the GAO report. We look forward to working with you as you continue to monitor the Year 2000 readiness of the financial services industry.

Very truly yours,



George M. Reider, Jr.
President



George Nichols, III
Vice President



Kathleen Sebelius
Secretary Treasurer



Glenn Pomeroy
Immediate Past President
Chair, Y2K Industry Preparedness Task Force

CC:Commissioners, Directors and Superintendents
Catherine J. Weatherford

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National Association of Insurance Commissioners

Year 2000 Chronology

The following reflects Year 2000 efforts undertaken by the National Association of Insurance Commissioners. The initiatives summarized below relate specifically to industry and state internal system preparedness and reflect the activity of the association. This document does not attempt to portray the separate activities of the individual states. In addition, NAIC support office readiness has been a priority, but activities relating to NAIC preparedness are not documented below, except in situations where an event had overlapping objectives.

Year 2000 Event Timeline

February 18, 1997	Year 2000 Awareness Presentation at 16 th Semi-Annual Regulators IS Conference
March - August, 1997	NAIC Year 2000 Survey of Insurance Companies
April - December, 1997	Year 2000 Section in Examiners Handbook
May, 1997	Evaluating Internal Controls in an Insurer's EDP Environment
July 15, 1997	Year 2000 Roundtable Discussion at 17 th Semi-Annual Regulators IS Conference
November, 1997	Evaluating Internal Controls in an Insurer's EDP Environment
December 9, 1997	Year 2000 Industry Awareness Report
February 10, 1998	Year 2000 Roundtable Discussion at 18 th Semi-Annual Regulators IS Conference
March, 1998	Evaluating Internal Controls in an Insurer's EDP Environment
March 14, 1998	Year 2000 Working Group Formed
April 8, 1998	Round Table on Year 2000 - Basle, Switzerland
May, 1998	Year 2000 Working Group recommends focus on domestic insurance entities
May - September, 1998	Insurance Regulatory Guideline for Industry Year 2000 Compliance and Remediation
June - September, 1998	Year 2000 Moratorium
July 27, 1998	Year 2000 Update at 19 th Semi-Annual Regulators IS Conference
August 1998 - Present	Participation in President's Joint Council
September 14, 1998	Opening Session - 1998 NAIC Fall National Meeting
September - November, 1998	Securities Valuation Office Year 2000 Guidelines
October 7, 1998	Year 2000 Summit
November, 1998	Year 2000 Task Force on Industry Preparedness
December, 1998	Market Analysis
January, 1999	Recommendation to include Year 2000 Disclosure in MD&A
January - March, 1999	Independent Validation and Verification of State Internal Systems Preparedness
January - April, 1999	Year 2000 Audit Program
February 8, 1999	Year 2000 Update at 20 th Semi-Annual Regulators IS Conference

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February, 1999	Uniform Agreement for Information Sharing
March, 1999	Supplement to State Examination Resources
June, 1999	Nationwide Contingency Planning

Year 2000 Event Detail

Year 2000 Awareness Presentation - 16th Semi-Annual Regulators IS Conference

The NAIC hosts two conferences for state regulators each year. They typically occur in February and July. At the February 1997 conference NAIC staff made a presentation to conference participants regarding Year 2000. This educational program focused on illustrating the problem, suggesting strategies for coping and providing guidance on focusing on the important issues.

Evaluating Internal Controls in an Insurer's EDP Environment

In May and November 1997, as well as March 1998, the Audit Software Subgroup held a training session for state regulators. In May 1997 there was a session on Year 2000. In November 1997 and March 1998, the new Year 2000 addition to the Financial Examiner's Handbook was included in the training schedule.

NAIC Year 2000 Survey of Insurance Companies

During the NAIC's 1997 Spring National Meeting, the Information Services (EX7) Subcommittee directed NAIC staff to propose a mechanism to evaluate the insurance industry's Year 2000 compliance. The NAIC then proposed surveying all insurers and at the NAIC's 1997 June National Meeting EX7 approved the proposal by directing the Information Systems Division to implement a Year 2000 survey of insurance companies on behalf of the state insurance departments. (Attachment A)

There were three objectives of the survey: 1) to provide an impetus for companies to take action; 2) to determine at a high level the degree of readiness in the insurance industry; and 3) to provide contacts for state examiners.

Year 2000 Guidelines in Examiners Handbook

In April of 1997 the Audit Software Subgroup began to evaluate an addition to the Information Systems Control Questionnaire to be included in the Financial Examiners Handbook. The Subgroup felt it was important to include a section specific to Year 2000. Over the course of several months this section of the handbook was reviewed and modified. In December 1997, the Year 2000 guidelines that were included in the Examiners Handbook had been forwarded through the NAIC Committee structure and approved unanimously. (Attachment B)

Year 2000 Roundtable Discussion - 17th Semi-Annual Regulators IS Conference

In July 1997 Year 2000 was given top billing in Roundtable discussions. Participating regulators discussed the many issues confronting them as insurance regulators, including examination, legal, and liquidation issues.

Insurance Industry Awareness Report - December 1997

In December 1997, a published report summarizing results of the August 1997 survey was released. (Attachment C) All companies responding to the survey indicated that they had plans to be Year 2000 compliant. Only 6.9% indicated that they were compliant at the time of the survey, a small number

indicated 1998 target compliance, while the majority of companies simply indicated that they would be compliant by December 31, 1999.

In addition to documenting survey findings, the report included four Year 2000 recommendations for regulators: 1) Ensure all significant companies are going to be prepared for Year 2000; 2) Minimize duplicate compliance efforts; 3) Communicate expectations of the industry; and 4) Develop and communicate a regulatory plan.

Year 2000 Roundtable Discussion - 18th Semi-Annual Regulators IS Conference

At the February 1998 Regulators IS Conference Year 2000 was again given a high priority. During Roundtable discussions participating regulators further discussed the many issues confronting them as insurance regulators, including examination, legal, and liquidation issues. Attention was focused on survey and examination efforts already underway at many insurance departments. Regulators agreed that a formal plan, including triggers, needed to be developed within the state insurance departments in order to ensure a consistent approach for reviewing and, if necessary, taking action against a company that would not be adequately prepared.

Year 2000 Working Group

In March 1998 the Information Services (EX7) Subcommittee approved the formation of the Year 2000 Working Group. The working group became effective immediately and held their first meeting in April 1998. The charges of the Year 2000 Working Group encompassed industry, state regulatory and NAIC preparedness for the new millennium.

Issues of immediate concern included recommendations made in the December 1997 Industry Awareness Paper. In addition, the Working Group collected information from the state insurance departments and the NAIC offices in order to publish quarterly reports that illustrated industry, state internal system and NAIC progress on Year 2000 projects. These reports were quarterly beginning in June 1998, and will continue through 2000. (March 1999 reports are attached as Attachment D and E)

Round Table on Year 2000 - Basle, Switzerland

On April 8, 1998 the NAIC was represented at a Round Table on Year 2000 hosted by the Bank for International Settlements. This event had several joint sponsors, including: Basle Committee on Banking Supervision (Basle Committee), the Committee on Payment and Settlement Systems (CPSS), the Internal Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO). More than 200 senior executives from 52 countries were in attendance.

Focus on Domestic Insurance Entities

In order to utilize state insurance regulator resources most effectively, the Year 2000 Working Group recommended that states concentrate their evaluation efforts on domestic insurance entities. However, the committee recognized that several states had already initiated Year 2000 monitoring efforts for all licensed insurance entities. For example, Texas and New York had already undertaken significant effort to ascertain the Year 2000 readiness of all licensed insurance entities.

Insurance Regulatory Guideline for Industry Year 2000 Compliance and Remediation

In July 1998 work was completed on this project. (Attachment F) The statement was designed to be a guideline for all interested parties, especially those that had not yet initiated their remediation efforts. Its purpose was to communicate state insurance regulatory expectations regarding a due diligence process that starts with the development of a Year 2000 project and leads to substantial compliance.

The paper states that 'in order to be prepared for the new millennium a company must ensure that its systems are substantially compliant. At a minimum, this means that the company must make requisite changes to all mission critical systems and must have contingency plans in place to address any material business processing interruptions that arise due to the Year 2000 computer problem.'

The paper clearly defined the regulatory role and expectations of insurance entities and provided a set of guidelines the insurers could use in completing their Year 2000 projects. In addition, the following milestones for insurance companies to meet in their remediation efforts were specified in the document:

- July 31, 1998 – Companies should already have completed the development of a written Year 2000 Test Strategy
- September 1, 1998 – Testing should have begun no later than this date.
- December 31, 1998 – Testing of internally developed mission critical systems should be substantially complete.
- March 31, 1999 – Testing of mission critical systems for which the company relies on outside suppliers should be substantially complete.
- June 30, 1999 – All mission critical systems should be in substantial compliance.

Finally, this guideline states that the last six months of 1999 should be used to focus on contingency planning for mission critical systems and, if time is available, remediation, testing and contingency planning for less critical application/systems.

Year 2000 Moratorium

In July 1998 the Year 2000 Working Group approved a Year 2000 Moratorium. (Attachment G) The objective was to adopt a statement that encouraged a minimum of regulatory changes that would result in the need for insurance entities to devote technical resources to these changes, thus diverting resources from Year 2000 preparedness efforts.

The Moratorium was forwarded to the Year 2000 Working Group parent committee, Information Services (EX7) Subcommittee and then to the Executive (EX) Committee for approval at the 1998 September National Meeting in New York. The committees unanimously approved the moratorium.

Year 2000 Regulatory Update - 19th Semi-Annual Regulators IS Conference

At the July 1998 Regulators IS Conference another Year 2000 presentation was made. Primary focus centered on NAIC and Year 2000 Working Group accomplishments since February 1998, as well as providing an information framework for regulatory activities over the next 18 months. Key events included the formation of the Year 2000 Working Group, the recommendation to have states focus monitoring efforts on domiciliary insurance entities, Year 2000 moratorium, Regulatory Expectations

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Paper progress, and quarterly reporting on insurance industry, state internal system and NAIC Year 2000 readiness.

President's Joint Council

In August 1998, the NAIC was requested to participate in the activities of the President's Joint Council. This includes on site meetings in Washington, D.C., conference call participation and periodic written reports regarding insurance industry preparedness. The NAIC is designated as the primary source of information on insurance sector year 2000 readiness. Since the Year 2000 Working Group has published quarterly reports on insurance company, state internal system and NAIC preparedness, information for President's Council reports has been readily available. The latest issue of a report was provided on March 9, 1999. (Attachment H)

Opening Session - 1998 NAIC Fall National Meeting

NAIC President Glenn Pomeroy (N.D.) highlighted the importance of a transition to Year 2000 during his opening session remarks at the 1998 Fall National Meeting. Comments included reiteration of regulatory responsibilities, as well as expectations and responsibilities of insurers.

Securities Valuation Office Year 2000 Guidelines

The NAIC's Securities Valuation Office (SVO), located in New York City, is responsible for the day-to-day credit quality assessment and valuation of securities owned by state regulated insurance companies. Insurance companies report ownership of securities to the SVO when such securities are eligible for filing on Schedule D or DA of the NAIC Financial Statement Blank. The SVO conducts credit analysis on these securities for the purpose of assigning an NAIC designation and/or unit price. These designations and unit prices are produced solely for the benefit of NAIC members who may utilize them as part of the member's monitoring of the financial condition of its domiciliary insurers. Unlike the ratings of nationally recognized statistical rating organizations, NAIC designations are not produced to aid the investment decision making process and therefore are not suitable for use by anyone other than NAIC members.

As part of its credit assessment procedures for not-rated securities, the SVO has an obligation to conduct due diligence on the obligor of each security before it can assign the security an NAIC designation. The SVO recognized the need to assess a company's Year 2000 preparedness as part of this due diligence. Therefore, the SVO drafted a series of questions relating to Year 2000 compliance to be answered by issuers/obligors (or entity/entities whose credit is being relied upon for the designation) of all not-rated securities filed with the SVO. These are to be included with each initial or annual update submission to the SVO of securities not rated by an NRSRO. If a response consisting either of the SVO's questionnaire or an acceptable substitute is not included as part of the submission, the filer may be contacted and asked for the response before the submissions can be assigned an NAIC designation for the current year.

These Year 2000 Guidelines were considered beginning in September 1998 and further refined in November 1998. (Attachment I)

Year 2000 Summit

In October 1998 the NAIC held a Year 2000 Summit for insurance regulators. The summit was a gathering of legal and financial regulators to facilitate the further development of strategies geared towards monitoring insurance companies and their Year 2000 remediation efforts. The summit included a

half-day session on contingency planning training and another half day focused on key issues for regulators (legal liability issues, communication, financial examinations, rehabilitation/liquidation).

Year 2000 Task Force on Industry Preparedness

The NAIC created a Year 2000 Industry Preparedness Task Force in November 1998 to focus exclusively on industry Year 2000 preparedness. During the first two months of 1999 the task force initiated and implemented several actions designed to supplement states' Year 2000 surveillance processes. The Year 2000 Working Group charge was then narrowed to focus on state preparedness, as well as NAIC readiness.

Market Analysis

In an effort to assess the size of the market in which assessment activity was already underway, the NAIC performed a market analysis. Taking into consideration all the state survey/examination efforts, monitoring of insurance company readiness is underway for 96.5% of the market.

Management Discussion and Analysis

Each year insurance companies are required to file a Management Discussion and Analysis exhibit with their statutory financial statement. State insurance regulators have incorporated a section on Year 2000 preparedness. In this regard, most insurance companies have provided insurance regulators with current information on the status of Year 2000 compliance in supplemental filings to annual financial statements. This information is similar to that which is required by the Securities and Exchange Commission of publicly held entities. The NAIC plans to utilize this information, along with other direct source information, to identify insurance companies that are at the greatest risk of a Year 2000 related failure. State insurance departments will be undertaking similar processes to reevaluate the readiness of insurers domiciled in their jurisdiction. (Attachment J)

Independent Validation & Verification of State Internal System Readiness

The Internal Administration (EX1) Subcommittee voted to contract with an outside consultant to perform an Independent Validation and Verification (IV&V) of state insurance department internal system preparedness in an effort to substantiate self-reporting. This project is well underway.

Year 2000 Audit Program

The Year 2000 Task Force has designed a comprehensive Year 2000 compliance audit program for state examiners to use on target examinations of insurers. A number of states have indicated intentions of conducting such examinations during the second and third quarters. The program is based on the Federal Financial Institution Examination Council's program and incorporates key insurance specific procedures from similar programs implemented by the New York and Texas Insurance Departments. Formal training in the execution of the program's procedures is planned for 150 state examiners in April.

Year 2000 Regulatory Update - 20th Semi-Annual Regulators IS Conference

At the February 1999 Regulators IS Conference a presentation was made, focusing on Year 2000 future activities. Key issues included quarterly reporting results, Management Discussion and Analysis Year 2000 disclosures, additional examiner training and an independent validation and verification of state internal systems.

Uniform Agreement on Information Sharing

A mechanism for states to share information arising from Year 2000 surveys and examinations has also been developed to efficiently and effectively survey the readiness of our industry. Presently, a majority of states, including several key states, have agreed to participate in process. The NAIC has, and continues to, encourage the free exchange of Year 2000 developed information among states. (Attachment K)

Supplement to State Examination Resources

At the 1999 March National Meeting the Task Force proposed that the NAIC provide further assistance to state insurance departments for Year 2000 monitoring, including assessment or remediation work on specific insurers and other regulated entities operating in multiple states.

Proposal plans are to allocate resources in situations where a state could benefit from additional Year 2000 resources. In addition, a framework for prioritizing and selecting states/insurers in need of these services will be completed by April 1, 1999.

The Internal Administration (EX1) Subcommittee approved the proposal.

Nationwide Contingency Plan

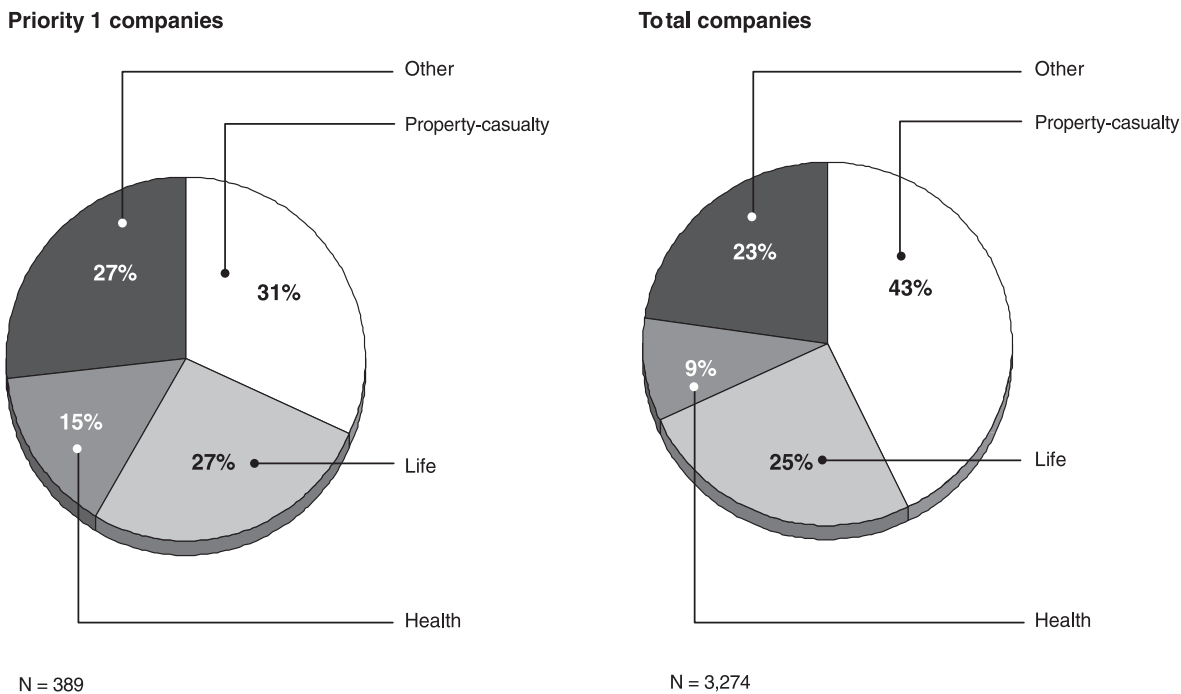
The Year 2000 Working Group proposed the development of a nationwide contingency plan for state regulators. This proposal was forwarded to the Information Systems (EX7) Subcommittee for consideration in March 1999, and the proposal was unanimously approved. The preliminary plan is to hold a contingency planning facilitated session in June 1999 in conjunction with the NAIC Summer National Meeting in Kansas City.

Attachments available from the NAIC upon request.

Priority 1 Companies Relative to Total Insurance Companies, by Type

Priority 1 companies represent those companies whose Year 2000 efforts were determined by state insurance regulators to need a high degree of regulatory attention. Thirteen of the 17 states we visited identified priority 1 companies, 2 states did not identify any priority 1 companies, and the remaining 2 had not completed their ranking process. The following figure presents a breakdown, by insurer type, of priority 1 companies, identified by the 13 states, relative to a similar breakdown of the total number of domiciled insurance companies in those states.

Figure IV.1: Priority 1 Companies Relative to Total Companies, by Type



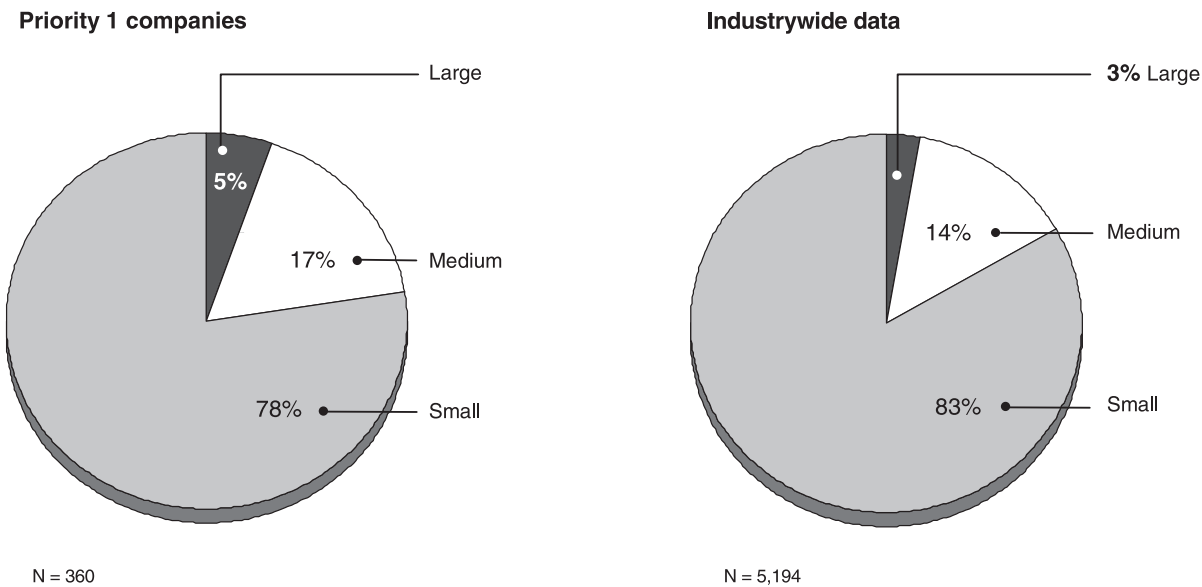
Note: "Other" may include such entities as fraternal, employee welfare funds, and title companies regulated by the state insurance departments.

Source: GAO summary of state survey responses.

Priority 1 Companies Relative to Industrywide Data, by Size

Priority 1 companies represent those companies whose Year 2000 efforts were determined by state insurance regulators to need a high degree of regulatory attention. Thirteen of the 17 states we visited identified priority 1 companies, 2 states did not identify any priority 1 companies, and the remaining 2 had not completed their ranking process. The following figure presents a breakdown, by size, of priority 1 companies, identified by the 13 states, relative to a similar breakdown using available industrywide data. Size is based on estimated net premiums written nationwide, with large companies writing more than \$1 billion, medium companies writing \$100 million to \$1 billion, and small companies writing less than \$100 million.

Figure V.1: Priority 1 Companies Relative to Industrywide Data, by Size



Source: GAO summary of state survey responses. Industrywide data by size was taken from an NAIC report, Year 2000 Insurance Industry Awareness, December 8, 1997.

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