



Insurance Commissioners' Association Avoids Disclosure and Charges the Public to Fund its Own Corporate Projects

Introduction

The National Association of Insurance Commissioners (NAIC) is an incorporated tax-exempt nonprofit organization that is treated, in some ways, as a quasi-governmental body. But, unlike most nonprofits or government bodies, the NAIC discloses only what the NAIC wants to disclose. The NAIC does not file the financial and public disclosures with the IRS that are normally required by other nonprofit charity-like organizations, including details of the organization's operations, financial performance, sources of income, payments to senior employees, operating expenses, investments and lobbying activities,¹ nor is it subject to state and/or federal open records laws and sunshine laws that would apply to governmental organizations. The apparent lack of transparency is disturbing to some.² Without IRS filings sworn under penalty of law, the public has no way to determine whether the corporation's preferential tax treatment is consistent with its operations, including: 1) whether corporation's activities go substantially beyond its charity nature; 2) whether it earns more revenues from private endeavors than charitable ones; 3) whether it spent more than, say, 10% of its activities influencing legislation; and 4) whether its activities produce some personal gain for its members.

This report analyzes the NAIC information available on the corporation's website. Our analyses of these documents, however, raise more questions than they answer, and highlight the need for increased transparency by the corporation. Moreover, this analyses find that state governments treat the NAIC, in some respects, as a quasi-governmental organization, passing laws that require state insurance companies to file documents with the NAIC and then pay the NAIC's database and filing fees. However, since the NAIC decides what those fees should be, the NAIC is effectively free to tax private insurance companies without any review or approval of state governments, and state insurance companies are obligated to make these payments under law. Even if a state government has the constitutional right to give tax authority to private corporations like the NAIC (a questionable assumption for some states), at a minimum, there should be safeguards assuring that the NAIC's fees are solely used for the purpose that lawmakers intended.

¹ Specifically, we are referring to 501(c) 3 nonprofit organizations.

² For example, see "NCOIL Leader to NAIC: Closed Door Meeting Defy Sunshine Laws," news release, National Conference of Insurance Legislators, May 4, 2007; and Kevin P. Hennessy, "The NAIC's Peek-A-Boo Legal Status," *Rough Notes*, July 7, 2007.

However, analysis of the NAIC's own information suggests that this is not happening. Instead, database and filing fees that are being collected by the corporation and are being used to cross-subsidize unrelated corporate activities, extending well beyond the very purpose authorized by state laws. The excessive taxing of businesses appears to be a misallocation of public resources, whose costs are ultimately borne by consumers in the form of higher insurance premiums. It is our conclusion that the NAIC should refund the excessive fees it has charged, and, going-forward, stop using these fees to cross-subsidize unrelated activities. Furthermore, the NAIC should begin filing with the IRS, including the extent of any lobbying activity, if necessary.

Looking Behind the Curtain

The NAIC is an organization made up of regulators (insurance commissioners) from the 50 states, the District of Columbia and U.S. territories. Starting as a voluntary unincorporated association in 1871, the NAIC became a Delaware registered corporation in 1999, and was granted tax-exempt status by the IRS as a 501(c)3 nonprofit, charitable and educational organization.

As mentioned, the NAIC does not disclose information normally required from other nonprofits. Although the IRS requires that all nonprofits – without exception – make their nonprofit documents available for public inspection in their home and regional offices, no documents were provided during our visit to the DC office on June 7, 2008.

In addition, the NAIC does not file an informational return with the IRS (Form 990) as all but the very smallest nonprofits are required to do. Instead, the public only knows what the NAIC chooses to disclose, namely news releases, annual and budget reports. The failure of the NAIC to file financial results with the IRS is ironic considering that one main role of the insurance commissioners is financial review of the companies they regulate. Kevin Hennosy, an insurance reporter and former public affairs manager for the NAIC, wrote:

The NAIC's reluctance to file a sworn public statement of its financial and business activities is very troubling to those who follow insurance regulation. Most important, all the information contained on a Form 990 is sworn to be accurate by an officer of the association. This is not true of NAIC budget proposals or press releases. Officers of nonprofit associations who knowingly file inaccurate or misleading information on a Form 990 are subject to criminal prosecution, jail time and fines.³

The IRS prohibits nonprofit 501c3 organizations from lobbying or influencing any legislation, with some exceptions that would require additional reporting of this activity to the IRS. Ten years ago, when the NAIC established its tax-exempt status as a 501c3 nonprofit, it reported to the IRS that it had no plans to do any lobbying, but, if it

³ Kevin P. Hennosy, "Insincerity: the Enemy of Clear Language: NAIC Shirks Standard Annual Financial Filings," Public Policy Analysis & Opinion, *Rough Notes*, February 2007.

ever did, it would measure the percentage of this activity.⁴ On May 7, 2008, then-executive vice president Catherine J. Weatherford said that the NAIC did not lobby.⁵

However, there is some evidence that NAIC has engaged in lobbying-like activities over the years,⁶ based on its role in writing and supporting model insurance legislation for the states,⁷ its advocacy before the U.S. House and Senate,⁸ its executive headquarters office in DC just two blocks from the Capitol,⁹ and its hiring of consultants that do professional lobbying.¹⁰

The NAIC drafts and recommends laws to its member and the states, many of which have been enacted into state law. Some state insurance laws specifically mention (by name) the “National Association of Insurance Commissioners,” including laws that require state insurance companies to file and make payments specifically to the NAIC.¹¹ How could such legislation pass without the knowledge, blessing and influence of the NAIC? While 501c3 nonprofits cannot act as advocacy groups (that distinction applies to 501c4 nonprofits), the NAIC has “advocated” for its model laws be adopted in all states and they track the adoption of these among the states.¹²

Commissioners, acting in a nonofficial capacity or as a representative of the NAIC, testify from time-to-time before the U.S. Congress on legislative matters. While this testimony is made at the direct expense and benefit of the NAIC, this testimony is sometimes available to the public on the state’s official department of insurance website, blending the state’s resources with the NAIC business.¹³

⁴ NAIC’s IRS 1023, pg. 4, 1999.

⁵ This was during a conversation at the NAIC office on 440 North Capital Street in Washington, DC.

⁶ Kevin P. Hennosy, “From KC to K Street,” *Rough Notes*, March 2006.

⁷ NAIC members write and adopt model laws. These model laws are written to provide a template for uniformity of laws among states. See, http://www.naic.org/documents/committees_models_faqs.pdf.

⁸ The NAIC writes:

“As part of our ongoing efforts, the NAIC coordinates with members to offer testimony to the U.S. House and Senate. NAIC members who are participating in committees, subcommittees or working groups within the association that address key regulatory and policy issues usually present this congressional testimony. One of the primary goals in testifying is to ensure states continue to have the ability to exercise their full range of powers to regulate insurance for the benefit of consumers.” See, “Services to NAIC Members,” NAIC, summer 2007, p. 10.

⁹ A \$345,512 annual lease for the DC office, according to the NAIC’s 2009 Budget at p. 85. Recently, the NAIC recently moved its executive from Kansas City to Washington D.C.

¹⁰ One contact was estimated to be one-quarter of a million dollars, according to Hennosy (2006).

¹¹ For example, the NAIC notes 19 states that require insurance companies to file with its SERFF system (<http://www.serff.com/>) and some require EFT payments directly to the NAIC (http://www.serff.com/documents/insider_090327.pdf). In addition, virtually every state requires financial data reporting (http://www.naic.org/urtt_fdr.htm#states) to the NAIC, which obligates private companies to make additional payments.

¹² For example see NAIC’s memorandum from Becky McElduff, senior council, to Commissioners, Directors and Superintendents, December 23, 2008, p. 2, which states:

“The Financial Condition (E) Committee and its Valuation of Securities Task Force advocated that the Derivative Instruments Model Regulation should be amended and adopted by all states ...”

¹³ For example, “Commissioner’s Efforts in DC,” see, www.floir.com/testimonypressreleases.aspx.

While influencing legislation is clearly prohibited by IRS rules and, if any were to occur it would require strict IRS reporting, the NAIC does not file this information with the IRS. The failure of the NAIC to file Form 990 means the organization avoids disclosing whether or not it “influences” legislation, even though it promised to do just that when it applied for its tax-exempt status.

Why does the NAIC not file a Form 990? The NAIC was ruled as a “wholly owned instrumentality” of the states in 1955. When it became a tax-exempt nonprofit in 1999, the NAIC assumed that the 1955 determination still applied, which exempts the organization from filing a Form 990 each year, if it so chooses. However, government entities are subject to Freedom of Information requests, as well as public oversight of budgets and appropriations. As a corporation, the NAIC gets the best of both worlds – it claims nonprofit status to avoid paying taxes to the IRS and it claims quasi-governmental status to avoid filing with the IRS.

How is the NAIC Funded?

In applying for its tax-exempt status with the IRS, the NAIC identified its sources of financial support in this way – “the Corporation will receive support from state governments, income from regulatory activities and sales of information.”¹⁴ Today, however, the state members contribute only 2.9% of NAIC revenue and sales from publications and from insurance data products account for 6.9% and 13.0% (respectively) of its projected 2009 budget. So, what is the corporation’s major source of revenues?

- ***Database Fees***

The biggest source of NAIC’s revenue comes from database fees, which are *budgeted* in 2009 to account for 35% of the corporation’s total revenue.¹⁵ The database system was established in order to help regulators, analysts and insurers by standardizing and mechanizing the reporting of insurance company financial reports. NAIC agreed in the early 1980s that the database fees charged to insurers would directly relate to the cost of creating and maintaining the database. Ironically, the financial reports that companies file with the NAIC contain much of the data that the NAIC reuses for its many financial publications and data products, which are sold to the public and produce another 20% of the NAIC’s revenue.

State laws now mandate that insurance companies file their financial reports with the NAIC.¹⁶ When these filings occur, the NAIC charges insurance companies based on the premium size of the companies in their previous year. By their own determination, the NAIC periodically raises the fees that insurers are required to pay. In order to comply with state laws, state insurance companies file with the NAIC, which unilaterally charges them for their data submission. Effectively, state laws mandate insurance companies pay the NAIC for filing their own data.

¹⁴ NAIC’s IRS form 1023 page 2, 1999.

¹⁵ 2009 budget has database fees accounting for \$25.6 million of the NAIC’s \$73.1 million in revenue.

¹⁶ See fn. 11.

The problem with this arrangement is three-fold: 1) it gives a private, tax-preferred, corporation (the NAIC) the sole discretion to determine the charges levied against other companies (the insurers); 2) it sets no limit requiring that the charges be commensurate with the costs required to collect, use and store the data, as the NAIC agreed to do when it first created the database; and 3) it circumvents the state budgetary processes, thereby allowing a private corporation (the NAIC) to levy taxes on independent business operations without meaningful due process – no representation, review, oversight, negotiation or approval. In fact, it may well be unconstitutional for some states to relinquish their taxing authority to other entities.¹⁷

How does the NAIC administer its database fees? The NAIC uses an internal administration committee to set funding requirements and associated fees. While the NAIC members are also state insurance commissioners, when approving the fees charged to businesses, the members are not acting in any official capacity as insurance commissioners of their state, but are simply acting as members of a separate corporation. Furthermore, because the NAIC does not have to file financial documents with the IRS, there is no legal financial document for determining what charges have been levied and how the money was actually used. Essentially, NAIC is allowed to tax private organizations, with no accountability for the collection or disbursement of funds.

Furthermore, an analysis of available budget data suggests that the tax-exempt nonprofit's Financial Reporting Services are, by usual measures, quite profitable.¹⁸ Assuming that the NAIC's budgets are accurate, the \$39.8 million that it expects to collect for Financial Reporting Services will incur \$5.1 million in costs, including salaries, payroll taxes, depreciation, overhead and other expenses.¹⁹ This means that the nonprofit's Financial Reporting Services are budgeted to generate about 8 dollars of revenue for every dollar of cost.

There is other evidence confirming the excessive profits derived from database fees. The NAIC 2009 budget estimates database fees to reach \$25.6 million in revenue, but only 2.9 million in operating cost.²⁰ Similar to the earlier estimate for Financial Reporting Services, this suggests that nearly 9 dollars of revenue are collected for every dollar of cost, an extraordinarily lucrative return for any business, much less a tax-exempt, non-profit entity.

- ***SERFF Fees***

Another way that NAIC collects revenues is from fees on its System for Electronic Rate and Form Filing (SERFF). To improve filing processes, many state laws

¹⁷ Based on a forthcoming (2009) white paper by Eli Lehrer, senior fellow at the Competitive Enterprise Institute, some state constitutions strictly prohibit states from surrendering, contracting or giving away any taxing authority to other entities – private or public. This means that many of current laws requiring state insurance companies to pay NAIC filing fees are potentially unconstitutional.

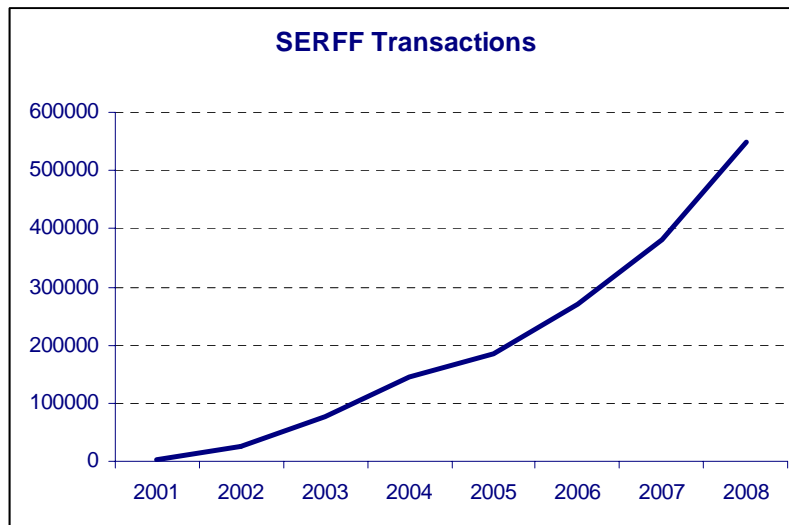
¹⁸ Financial Reporting Services include mostly database filing fees (64%), along with publications and subscriptions (33%), and some interest and indirect income (3%).

¹⁹ NAIC's 2009 budget report, p. 218.

²⁰ Ibid, p. 22, financial data repository costs.

now require insurance companies to file their rate and form changes with the NAIC,²¹ which means that insurance companies must pay NAIC's fees in order to execute these filings. As mentioned earlier, it is not clear if it is constitutional for some states to legislate away taxing authority to a corporation or any other entity for that matter.

Since 2001, the number of individual SERFF transactions has increased at an annual average compound rate of 104%. As the chart below shows, there were 3,694 SERFF filing transactions in 2001 and by one estimate there were about 550,000 in 2008.²² General characteristics of online computer systems typically describe high fixed costs for equipment and software, and near zero marginal costs for each transaction. Relating these economies of scale to the SERFF system, the historically rapid increase in filing transactions should have resulted in sharply declining system costs per transaction. However, evidence suggests that the NAIC is not pricing its SERFF filing fees with regard to costs. A review of the budget reports show there has been no appreciable reduction in fees that demonstrate that cost savings are being passed along to the tax-supporting public – namely, insurers and consumers. In fact, SERFF revenues per transaction did not decline from 2006 to 2007, while revenues grew by 45%. In 2008, according to NAIC budget reports, only a modest reduction in fees is implied in the data.



If SERFF fees per transaction have not declined as fast as system costs per transaction, the profitability of SERFF should be high and a review of the NAIC's budgets supports this hypothesis. In 2009, NAIC is expected to collect \$4.0 million from SERFF filings and will incur \$1.0 million in operating costs,²³ meaning that 4 dollars are collected for every 1 dollar of costs. This conclusion is supported by other analyses, indicating that SERFF is quite a profitable line of business.²⁴

²¹ See <http://www.serff.com/about.htm>.

²² The cited figure comes from "SERFF Surpasses 500,000 Transactions," NAIC News Release, NAIC, December 6, 2008.

²³ Revenues came from the NAIC 2009 budget at p. 53; costs from p. 22

²⁴ Eli Lehrer, untitled white paper, forthcoming, 2009.

Similar to the database fees, SERFF fees are mandatory in many states, meaning that members of NAIC can collectively set these rates as they wish and require insurance companies to pay these fees without any state review and without state approval as to the reasonableness of these charges. While companies pay these fees, these costs are ultimately borne by consumers in the form of higher insurance prices.

Where Does all of the Money Go?

NAIC collects the bulk of its money from fees charged to insurers for filing financial information and sale of its publications, but it also collects revenues from education and training, investment and other services. From 2003 to 2008, the nonprofit organization appears to have earned \$33 million in profits. While the NAIC is expected to earn profit in its financial reporting services, it is expected to lose money in almost every other service it provides. This means that database fees and SERFF fees are being set artificially high to cross-subsidize other activities for the NAIC, rather than asking the members to pay more for these money-losing activities. The problem with this cross-subsidy is that states have legislatively required insurance companies pay the NAIC for its SERFF and database filings, but the NAIC is collecting more than it needs to recover its SERFF and database costs. Effectively, the NAIC uses these state laws to overreach and misallocate public resources for the NAIC's corporate benefit.

The NAIC establishes a membership "fee" for each state department of insurance that is based on insurance premiums paid in the state. However, the amount each commissioner's department receives back from the NAIC in the form of scholarships and travel stipends is almost twice as high as the fees that they pay through their state assessments.²⁵ For example, in the 2009 budget, revenues to fund commissioner membership services (primarily state assessments) were estimated to be \$2.1 million, while expenses associated with commissioner membership services totaled \$4.0 million.²⁶

Assuming that the NAIC's self-disclosed information is accurate,²⁷ the corporation reimburses the travel expenses of all commissioners who attend NAIC national meetings and the Commissioner's Conferences, as well as the expenses of any department staff or other participants who come as speakers or instructors, or come at the request of NAIC. For example, when the New York State insurance commissioner testified before Congress on May 16, 2008, NAIC paid the commissioner's expenses, including his one-day cost of \$855 for a car rental and \$376 for other ground transportation.²⁸

²⁵ NAIC 2009 Budget, p. 220.

²⁶ Ibid.

²⁷ Emails from New York Commission staff in response to a freedom of information request made by ACI claimed (more than once) that New York does not pay any state assessment to NAIC. However, NAIC reports that these payments are made. We cannot be sure which source is inaccurate.

²⁸ New York State Insurance Department Response to a FIOL request #2008-001375-NYC.

While it may not be completely clear what the public benefits are derived from the international travel by state-based regulators and their staff, in recent years, commissioners have taken business trips to Buenos Aires, Seoul, Beijing, Brussels, Geneva, Basel, Rio De Janeiro, Quebec, London and elsewhere that were paid or reimbursed by the NAIC.²⁹ To highlight this imbalance between what states pay as a “membership fee” directly to the NAIC and what commissioners receive in return, during the period from January 2006 to June 2008, the NAIC paid the Virginia Insurance Commissioner \$65,519 worth of international travel.³⁰ In contrast, Virginia’s entire annual state assessment paid in 2007 to the NAIC was \$46,498.

The NAIC also subsidizes activities that benefit state insurance commissioners and their staffs, including general meetings, training and education, accreditation and many other areas. While these expenses may be legitimate, it would appear that the NAIC benefits from overcharging insurers in order to subsidize public officials acting in an unofficial role on behalf of a private corporation. While state legislation may require payments to NAIC for certain identified database activities, when these payments exceed the cost of the NAIC’s database services, the excessive taxation would appear to violate the intent and purpose of this legislation.

Besides using excessive earnings to support unprofitable activities, the NAIC is building a sizable fund for future use. Specifically, the NAIC appears to be accumulating these excessive earnings and stowing them into an impressive capital reserve account. According to numerous documents, the NAIC’s stated goal is to *increase* its reserves to 80% of annual operating costs – a 10 month cash reserve.³¹ The problem with this collection of reserves is that much of the sources of revenues did not come by voluntarily payments or contributions to the nonprofit.

Calling the Kettle Black

Evidence presented in this paper shows that the nonprofit earns supernormal profits from charging the industry high database and SERFF filing fees, which pass these costs along to consumers in the form of higher insurance premiums. To put this profitability into context, from 1987 to 2006, the automobile insurance industry earned 9.3% return on net worth and -1.2% in underwriting profit; and for homeowners insurance the industry earned 0.7% return on net worth and -11.4% in underwriting profit. These insurance industry returns are at or below those earned by most other competitive industries.

Typically, competitive industries exhibit normal returns, because high profits are competed away by market entry and rivalry. However, state insurance laws requiring

²⁹ See NAIC calendar http://www.naic.org/documents/committees_g_international_calendar.pdf for some examples.

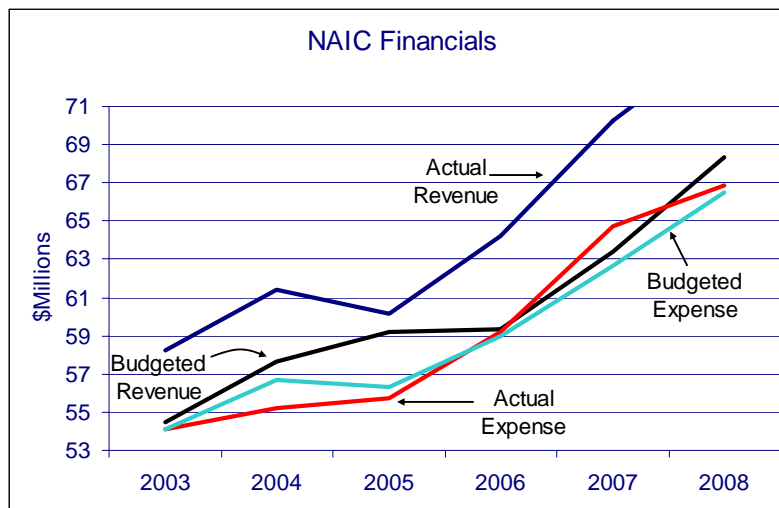
³⁰ Correspondence dated July 11, 2008 from the Associate General Counsel, Commonwealth of Virginia, State Corporation Commission in response to ACI’s request for documents/information under the Virginia Freedom of Information Act.

³¹ A recent mention of this 80% liquid reserve is discussed in “Internal Administration (EX1) Subcommittee Public Budget Hearing Conference Call,” NAIC, November 5, 2008, p. 1.

businesses to file and pay the NAIC and the NAIC's pattern of setting its prices well above costs are indicative of market power. In the past, insurance commissions, including those in Florida,³² Texas,³³ Maryland,³⁴ New Hampshire,³⁵ Washington State,³⁶ North Carolina,³⁷ California³⁸ and others, order refunds when they believe parties are being overcharged. These commissioners, as members of NAIC, should do the same to remedy the overcharging for database and SERFF activities by NAIC. To do otherwise is an abuse of the public's interest.

How Good are the NAIC's Data?

As mentioned, rather than file annual information with the IRS, the NAIC publishes its estimated budget. However, budgets can be wrong and, as far as the NAIC is concerned, they frequently have been wrong. In fact, a look back at the difference between budgets and final results suggest that the NAIC is consistently underestimating its revenue forecasts. As the chart (below) shows, the NAIC actual revenues always come in much higher than its budgeted revenue from year-to-year. As shown in the chart, the same problem is not evident in the budgeting of expense.



³² "Fla. Insurance Commission Orders State Farm to Refund \$120 Million to Policyholders for Unpaid Mitigation Discounts," news release, Florida Insurance Council, Sept. 9, 2008.

³³ "Insurance Commission Orders Allstate to Reduce Rates," press release, Texas Department of Insurance, May 22, 2006.

³⁴ "Maryland Insurance Commissioner Orders \$4 Million Returned to Maryland Citizens," press release, Maryland Insurance Administration, May 1, 2003.

³⁵ "New Hampshire Insurance Commissioner to Order Premium Refunds on Workers' Compensation Policies," Insurance Department Press Release, New Hampshire Insurance Department, June 16, 2005.

³⁶ "Insurance Commissioner Orders Refunds to Doctors on Malpractice Coverage," Older Americans Report, March 4, 2005.

³⁷ "North Carolina Insurance Commission Settlement Means Refunds for Drivers," Wilmington Star-News, July 23, 2004.

³⁸ "California Insurance Commissioner Steve Poizner Announces He Will Seek Refunds for Allstate Customers," press release, California Department of Insurance, May 23, 2007.

This underestimation of revenues cannot be explained as a random outcome. Specifically, there is a 98.4% probability that the direction of the errors could not have occurred by chance.³⁹ But, why would the NAIC consistently, and perhaps purposely, underestimate revenues and not expenses?

One possibility is that, by underestimating the projected growth in revenue, the difference between revenues and expenses appears smaller, at least on paper. However, when revenues come in much higher, the organization can sop up the excess by sharply increasing expenses. If official results are not filed with the IRS, the public is left with relying on next year's budget projections, projections with dubious accuracy that cloak, in part, the overcharging and redistributing of excess revenues into other projects.

Summary

This analysis raises questions about the NAIC and shows the need for better information, more transparency and fuller disclosure. The NAIC is an corporation with a public purpose that includes the collection and disclosure of industry financial, solvency, rate and form filing information, but it does not provide the same financial transparency of its organization to the public; it is a tax-exempt company with a *de facto* delegated tax authority over private firms; it is a nonprofit organization that appears quite profitable; it operates like a governmental unit without any government transparency, without government financial oversight and without being subject to freedom of information requests; and, finally, it is the chief organization supporting the maintenance and proliferation of state insurance regulations, but it answers only to its members, who have no authority to act in any official public role for the states or the nation as a whole.

This analysis also suggests that the NAIC is overcharging state insurance carriers, who simply pass these excess charges along to consumers in the form of higher prices. The NAIC should refund these overcharges, for the benefit of consumers, and establish future filing and database fees to reflect direct costs. For the NAIC to act as an instrumentality of the government, it should also act in the public's interest and not the interest of the corporation.

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³⁹ Assuming that overestimation and underestimation are equally probable, the underestimation of revenues for 6 consecutive years could only have occurred by chance with a 1.6% chance (or 50%⁶).