[INSIGHT] By Peter H. Bickford

Disconnection

One of the most important tasks in advising insurance company or producer management over the years has been to stress the importance of reporting violations – no matter how minor, incidental or innocent – to the regulatory authorities. The challenge is to overcome management's fear of repercussions that often outweighs the potential consequences of not reporting. And if the violation happens to have been by another company or agency – even if the violation is malicious or fraudulent – there is a fear that the reporter rather than the offender will end up being the one investigated and pursued by the regulators or possibly even subject to prosecution. Unfortunately, these fears are not totally unfounded, and the reality today may be more evident than in the past, particularly with the trend toward bundling financial services – including insurance – under one roof. This bundling has brought a new, aggressive enforcement mindset to financial services regulation, including insurance, and a growing disconnect between regulators and the industries they regulate.

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The most egregious examples, of course, become the battle flag for the company or agency fearing unwarranted reprisals for "doing the right thing." Take, for instance, the criminal case against Abacus Federal Savings Bank, a small community bank in Manhattan, which in 2009 discovered that an employee had been engaged in a fraudulent mortgage scheme. The employee was fired, an internal investigation undertaken, the banking authorities informed and all of its files opened to the regulators.

In repayment for its vigilance, the bank and a number of its employees ended up the subject of a 184-count criminal indictment in 2012, with – incredibly - the fired mastermind of the fraudulent scheme as the prosecutor's primary witness. In June, a jury fully exonerated the bank by acquitting the bank and its senior officers of all 80 counts of the original indictment remaining at trial. Five-and-a-half years after doing what it thought was the right thing, the nightmare for the bank may have finally been over, but at a tremendous cost – financially and to its standing in the community.

Despite the jury's total exoneration of the bank, the DA's office expressed disappointment adding that: "We are confident that as a result of this prosecution and enhanced supervision . . . the fraud perpetrated within the loan origination department has been terminated." Tiny Abacus, apparently the only banking institution prosecuted for mortgage fraud by New York's current DA, was certainly a strange choice as poster child to demonstrate strong action against fraudulent mortgage schemes pervasive in the 2008 financial crisis. Abacus never wrote subprime business, did not need bailout money, had a stellar record for over 30 years in the community, and none of the relatively small number of questionable mortgages resulted in losses. The only loser was the bank and its reputation.

How such an action against a small local bank acts as a deterrent to bad actors is not very clear. As the bank's founder commented after the acquittal, what the prosecutor accomplished was to "make a small bank weaker" and to "scare the community." He could have added that the prosecutor's action has reinforced the perception that only the little guy gets punished when big guys do bad things, and that doing the right thing only gets rewarded in John Wayne movies. What it does not do is make it any easier to convince innocent players to report bad actions by rogue employees, to admit to innocent errors or lapses in compliance, or even to fix flaws in compliance for fear such steps may be considered to be a cover up.

True, it was the DA's office and not the bank's regulators that pursued prosecution. But where were the regulators while the prosecutors were in full bore after the bank? Were they supportive of the prosecution? Did they reach their own different findings on responsibility for the fraudulent scheme? Did they have any input to the DA's decision to prosecute? One thing is clear, however: they did not come to the rescue of an institution under its supervision and under an attack that could seriously jeopardize its very existence.

What does this mean for regulated insurance companies and producers? With the bundling of financial services under uni-regulators, the distinction between the treatment of insurance entities and other financial services is disappearing. Viewed in this light, the response – or non-response – by the bank's regulators in the Abacus Bank matter provides a warning to beware the consequences of this new, aggressive enforcement standard of regulation, and the growing disconnect between regulators and the businesses they regulate.

There is another recent non-insurance analogy of interest. In the face of criticism that it does not give companies enough credit for diligent compliance programs when they fail to stop a rogue employee, the US Justice Department recently announced that it would appoint a com-

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pliance counsel to help it determine who to prosecute. In other words, the Justice Department apparently determined that it needed another set of eyes to tell if the target company was truly vigilant in its compliance program or merely seeking to minimize fines or disciplinary action. The distance between enforcers and regulated companies has grown to the point where the enforcer cannot tell good from bad players in their midst.

It is this disconnection that is most troubling for the regulatory practitioner. There was a time in the not-so-distant past when regulators were actually required to know something about the business being regulated. But the prosecutorial mentality has been overtaking the regulatory field for some time now. Law enforcement experience over knowledge of the business seems to be a primary qualification for employment by insurance regulatory agencies today. As the gap of knowledge about the business of regulated companies widens, regulators are more and more likely to treat all violations, mistakes and oversights the same, whether borne from indifference, intentional abuse or mere mistake.

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It was not always so. There was a time when regulators and industry representatives actually talked to each other about important issues; when, for instance, NAIC working groups regularly invited insurers, brokers, intermediaries, trade associations, consumer groups and other industry experts to participate; when regulated entities and third parties had meaningful input before new laws or regulations were promulgated; and when it was important that regulators actually possessed more than just a superficial knowledge of the business of insurance.

Understanding of the business of insurance is no longer necessary. Schooling in law enforcement is the new curriculum.[IA]

Peter Bickford has over four decades of experience in the insurance and reinsurance business, with particular focus on regulatory, solvency, agency, alternative market and dispute resolution issues. In addition to his experience as a practicing attorney, he has been an executive officer of both a life insurance company and of a property/casualty insurance and reinsurance facility. A complete biography for Mr. Bickford may be accessed at www.pbnylaw.com.