Final Report

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"The Path to Reform –The Evolution of Market Conduct Surveillance Regulation"

Prepared for the
Insurance Legislators Foundation
by

PricewaterhouseCoopers LLP
and
Georgia State University

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EXECUTIVE SUMMARY

James Schacht of PricewaterhouseCoopers (PwC) and Dr. Robert Klein of Georgia State University are pleased to present to the Insurance Legislators Foundation (Foundation) "The Path to Reform – The Evolution of Market Conduct Regulation." PwC's Insurance Regulatory and Compliance Solutions Practice (IRCS) has prepared this report, with Dr. Klein, Associate Professor in the Department of Risk Management and Insurance and Director of the Center for Risk Management and Insurance Research at Georgia State University.

This report represents Phase II of our Insurance Market Conduct Examination Public Policy Review. Phase I of that study was presented to the Foundation on July 6, 2000. Phase II builds upon that study and recommends a regulatory framework for a reformed market conduct surveillance system from which specific procedures and public policy can be developed.

Phase I of our Insurance Market Conduct Examination Public Policy Review examined the current system for market conduct surveillance utilizing a survey of state insurance regulators and insurers and other information. With this foundation, Phase II proceeds to develop a more effective and efficient regulatory framework for future market conduct surveillance. Part I of Phase II addresses the purpose, objective, and principles of market conduct regulation and surveillance. Part II of Phase II presents detailed recommendations for specific components of a transformed system and how it should be implemented.

Many have commended the ILF for undertaking this public policy study of market conduct surveillance, as it is the first comprehensive review conducted since the McKinsey report in the early 1970s. The McKinsey report suggested the separation of financial and market conduct surveillance activities and is generally viewed as a 'defining' event which resulted in the present market conduct surveillance system. Unquestionably the ILF's interest in this subject has stimulated the ideas and discussion currently occurring with respect to market conduct surveillance within the NAIC and the insurance industry – all are searching for ways to make market conduct surveillance efficient and cost effective in today's environment. We do not believe that this report represents the final word or view on the subject, but rather it will be helpful to the ILF and others to develop appropriate public policy in this important area of regulation. Market conduct regulation, although secondary to financial condition surveillance, is critical to insuring the welfare of consumers and maintaining public confidence in the insurance industry.

To 'set the stage' for our recommendations with respect to the purpose and objective of market conduct surveillance, as well as Part II of this report, we have included background and introductory commentary, and a Preview of Part II, which is briefly summarized as follows:

Part I Background and Introductory Commentary

Project Background

This section includes an overview of our Phase I report findings. We discuss the importance of establishing a clear vision of the purpose and objective for market conduct surveillance. As we noted in Phase I, one of the obstacles to achieving significant improvements in this very important regulatory function has been the vagueness that continues to exist about what the system is supposed to accomplish. In fact, we conclude that the 'what' and 'why' of the system must precede the 'how' of that system. Further, we discuss how market conduct regulation reforms must be a part of a regulatory scheme that is efficient and based on sound economic principles. Next, we discuss how insurance markets and the industry have evolved since the early 1970s and the implications of this evolution for regulation. Finally, we define certain terminology that is used in the report.

Introduction and Overview

In this section we discuss how market conduct regulation including surveillance must evolve consistent with market changes and the development of regulatory and commercial institutions. We observe that it is time for market conduct surveillance to mature and become less parochial in order to better serve consumers and remove unnecessary impediments to interstate commerce in insurance. Its regulatory participants must recognize that it must become a part of a national system of regulation that is more integrated, standardized and uniform. Further, we note that the system should take account of a company's compliance efforts and self critical analysis programs, and should also incent and reward companies that do so. The system should encourage and reward a corporate culture that places importance on fair treatment of policyholders. We believe regulators should be offering guidance to companies on how to conduct such programs to meet regulatory standards. We include an overview of the NAIC's current reform initiatives and the insurance industry's and insurance consumer organizations' view of these efforts. Finally, we discuss the economic theory of insurance market regulation.

Part II

This section discusses the final phase of our work that presents detailed recommendations on the 'nuts' and 'bolts' of a revamped market conduct regulatory system based on the suggested purpose and objectives, which are set forth in this report. This includes, but is not limited to: 1) key provisions of a model market conduct surveillance law, 2) interstate cooperation and communication, 3) the types, scheduling and scope of examinations, and 4) establishing compliance standards for insurers.

The following briefly summarizes our findings and observations on the present system and our recommendations on the purpose and objectives and underlying philosophy for an improved market conduct surveillance system:

- Fundamentally, there needs to be a rethinking of the philosophy and approach towards market conduct regulation and surveillance. In many respects, regulators have become defacto 'quality control auditors' for insurers. This is not an efficient use of regulatory resources and does not serve the public interest.
- The present system has become extremely parochial with standards and practices varying from state to state, based more on a matter of taste than necessity, which increases the cost of insurance transactions unnecessarily.

States have a vital and mutual interest in the market conduct of companies, just as they do in the financial condition of companies. As with financial regulation, market conduct surveillance policies and actions should be properly focused, standardized and streamlined. Further, the regulation of the market conduct of an insurer in one state affects the interests of all other states in which that insurer conducts business.

- States have a vital and mutual interest in the market conduct of companies, just as they do in the financial condition of companies. As with financial regulation, market conduct surveillance policies and actions should be properly focused, standardized and streamlined. Further, the regulation of the market conduct of an insurer in one state affects the interests of all other states in which that insurer conducts business.
- Corporate culture determines how an organization behaves when not being watched. The market conduct surveillance system should encourage and reward companies that place a high priority on fair treatment of policyholders, regulatory compliance, and remediation efforts made when non-compliance is discovered. Market conduct expectations should be communicated clearly to the insurance industry.
- Market conduct surveillance should focus on the overall performance of insurance markets and prioritize the most important areas requiring regulatory attention with appropriate, targeted strategies and remedies.
- We propose the following elements for an effective and efficient framework for market conduct surveillance regulation:
  - An integrated system for identifying, assessing and prioritizing market conduct problems. The goal would be to create a net that would be expected to catch most if not all significant problems but also avoid unnecessary duplication and waste of resources. Detected or suspected problems would be prioritised for regulatory attention. Ideally, all states would work together in operating such a system and use it to assign tasks to the participating regulators.
  - A mechanism for developing and implementing appropriate strategies and means to remedy significant market conduct problems.
  - A program for complete communication and coordination among states to make the most effective use of regulatory resources.
  - A procedure for assessment of regulatory performance and effectiveness in addressing significant market conduct problems as well as market outcomes.
- We believe that the purpose of market conduct regulation and particularly examinations should be to prevent and remedy unfair trade practices that have a substantial adverse

impact on consumers, policyholders and claimants. Resources should not be wasted on detecting and correcting minor processing errors or inadvertent minor violations of laws and regulations. Regulators should pursue substantive abuses and take actions that will result in the mitigation of the greatest harm and restoration of the greatest benefit to consumers and the public.

Part II Recommendations

Recommended Market Conduct Surveillance System Reforms

Before describing our recommended reforms for the U.S. market conduct surveillance system, we inform the reader in this section of two important matters. First, we begin with a brief restatement as to how and why we arrived at these suggestions, which are presented in greater detail in the first part of this report. Secondly, we explain why our suggestions are presented in a less than fully developed fashion.

Underlying our recommendations is the fact that things have changed dramatically since the early 70's, when McKinsey & Company first recommended to the NAIC that market conduct surveillance activities should be separated from financial surveillance activities.

One of the dramatic changes since the 1970's is that insurers have significantly and continually increased their attention to compliance matters and fair treatment of policyholders. Every well-run company today has a chief compliance officer or similar position, written policies and procedures for all compliance functions and a comprehensive support structure for effective implementation. We do not believe that a market conduct surveillance system should exist to perform what amounts to "quality control" functions for insurers; however, in large part this is what the present system does.

Some will criticize our proposals as either impossible to achieve because of the differences in state laws or because we have failed to recognize that differences exist. Setting aside the question of whether the differences are essential or merely preferences, those that harbor these feelings have failed to grasp what we are trying to achieve – imposing a high standard on insurers and regulators that oversee them. Market conduct surveillance should have as its goal, objective and purpose – creating an environment that results in ethical behavior and a proper corporate culture and philosophy reinforced by standards, systems and controls that seeks to achieve not only compliance with law, but fair treatment of policyholders in accord with the insurance contract. Such an approach as we will later describe is being pursued by other regulatory bodies.

With most state governments suffering from budgetary problems, this should provide further motivation to have a market conduct monitoring system that 'works smarter,' is more agile and relies on insurers to do their part.

Our charge was to develop the essential elements or general nature of a new market conduct surveillance system based on our Phase I findings, our knowledge of the industry and criticisms of the present system. We do not believe these recommendations represent the final word or view on the subject, but rather it is hoped that it will help the ILF and others to develop appropriate public policy in this important area of regulation. Therefore, our recommendations are not presented in a fully developed fashion. If these recommendations are deemed worthy of pursuit, the steps toward implementation outlined in this report can be commenced.

Overview of Key Elements

This section of the report details the general nature of the key elements of our recommendations for reforming the market conduct surveillance system. We believe that these changes will result in a system that is more effective, efficient and cost beneficial to all stakeholders – consumers, the insurance industry and state government.

Our recommendations include the following key elements each of which will be discussed in the sections that follow:

- Vest the domiciliary state with primary responsibility for performing market conduct surveillance of an insurer or a group of affiliated insurers. (See Section B)

- Enhance the NAIC's National Complaint Database, allowing it to serve as a resource for consumers as well as a valuable tool for market conduct surveillance (See Section G).
- Develop guidelines to be promulgated by insurance regulators, which describe standards for an insurer's compliance program including systems and controls that will seek to ensure compliance with the laws and regulations but more importantly, fair treatment of policyholders and adherence to contract terms. (See Section C)
- Conduct mandatory periodic dialogues between compliance officers of insurers and market conduct regulators to discuss relevant new laws and regulations and their interpretation, problems encountered in market conduct examinations or otherwise, and recent enforcement actions. (See Section D)
- Continue to use the market conduct examination as a key regulatory surveillance tool, but limit its use to insurers with actual or perceived problems. Consistent with our prior recommendation, the examination will be conducted by the domiciliary state of the insurer (or the state in which the largest number of a group of affiliated insurers is domiciled). Non-domiciliary states will designate an 'association reviewer' to oversee the conduct of the examination. (See Section B)
- Embed market conduct surveillance into other regulatory functions. (See Section E)
- Create a National Market Conduct Oversight Committee to maximize interstate communications, cooperation and coordination. (See Section F)
- Develop a model law on market conduct surveillance which will create a statutory base for this activity and that is predicated upon the recommendations we have made. (See Section B)
- Encourage adoption of the model statute to protect the confidentiality and privileged status of self-evaluation audits and independent assessments. (See Section I)
- Reward companies that participate in independent standard setting and assessment programs. (See Section H)

While we have recommended that the domiciliary state should assume the responsibility for market conduct surveillance, we believe it would be desirable to have a procedure whereby the non-domiciliary states can participate and oversee an examination being conducted of a multi-state insurer.

Therefore we recommend that a new examination position be created, that being 'Association Reviewer.'

Rationale Underlying the Reformed System Being Recommended and How Market Conduct Surveillance Will Be Improved.

- The insurance industry has changed dramatically since the 1970s, when the McKinsey Study was done.
- The majority of companies want to be in compliance.
- In this new paradigm of market surveillance, companies will be given "best practice" guidance on what a model compliance structure looks like.
- This new system is based on the underlying premise that insurance companies are in business to treat policyholders fairly, and only companies that violate that trust without reparation should be pursued and punished.
- This new system will be proactive rather than reactive. It will place emphasis on evaluating "patterns" of market conduct practice, not the detection of individual incidents of deficiencies.
- The new market surveillance system will encourage companies to embed compliance within their organization.
- Companies that have adopted a sophisticated approach to compliance and the necessary internal controls will receive less regulatory scrutiny.
- This new system will actually allow regulators to be more vigilant and to provide quicker correction and remediation of significant problems.

Implementation of the New Market Conduct Surveillance System – Next Steps

Our recommendations are not an ad-hoc incremental process oriented approach to address the deficiencies and shortcomings of the current system. It is a dramatic rethinking of how the system should be designed. With this in mind, we offer suggestions in this section for the next steps and implementation.

Effect of Proposed Changes

This section includes a chart, identifying how our recommended changes to market conduct surveillance will overcome the deficiencies in the current system. The deficiencies are those we have identified in our Phase I and subsequent work, many of which have been recognized by the NAIC, consumer groups, the insurance industry and others.

PREFACE

James Schacht of PricewaterhouseCoopers (PwC) and Dr. Robert Klein of Georgia State University are pleased to present to the Insurance Legislators Foundation (Foundation) "The Path to Reform – The Evolution of Market Conduct Regulation." PwC's Insurance Regulatory and Compliance Solutions Practice (IRCS) has prepared this report, with Dr. Klein, Associate Professor in the Department of Risk Management and Insurance and Director of the Center for Risk Management and Insurance Research at Georgia State University.

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PART I – BACKGROUND, INTRODUCTION AND OVERVIEW

I. PROJECT BACKGROUND

A. MOTIVATION FOR STUDY OF MARKET CONDUCT REGULATION PUBLIC POLICY

The Foundation provides a public service in the form of non-partisan research and technical information to state governments by educating and informing state legislators on public policy issues arising from insurance-related legislation and regulation.

In 1998, the Foundation issued a Request for Proposals for a Public Policy Review that would review and analyze the market conduct examination activities of U.S. insurance regulatory authorities. The purpose of that Public Policy Review was to educate and inform state legislators on the public policy issues arising from these examination activities and to promote effectiveness in the best interests of public welfare. PricewaterhouseCoopers and Dr. Robert Klein were commissioned to conduct this review.

B. CONTEXT FOR FURTHER STUDY OF MARKET CONDUCT REGULATION/PHASE I FINDINGS

Phase I of our Public Policy Review reviewed and analysed the market conduct activities of the various states. Through a series of surveys of the two primary participants, state insurance departments and insurers, as well as other information and analysis, we provided the Foundation with the insights and information it was seeking. In keeping with the progressive nature of this public inquiry, we were cautious in making judgements about the efficacy and efficiency of current policies and systems. Also, it should be noted that while our surveys included all but a few state insurance departments, our surveys of insurance companies were limited. We offered observations about certain aspects of the current system that further contributed to the recommendations contained in this report. Our observations on several important topics, which were based upon the findings of our work, are summarized below:

1. Philosophy and Purpose of Market Conduct Surveillance

- Regulators' view of the fundamental purpose and objectives of market conduct surveillance, i.e. their philosophy is key to understanding how they perform this important regulatory function. While the philosophy governing market conduct surveillance is reflected in statements that first appeared in the McKinsey Report (discussed below) and subsequently appeared in various editions of the NAIC Market Conduct Examiners Handbook (Handbook), these statements reflect an "ideal vision" adopted by the NAIC. Our survey found that individual state departments and regulators have differing visions of market conduct surveillance, contributing to varying policies and approaches. Moreover, regulators face a number of realities in implementing their responsibilities and actual practices may vary from ideal notions.

- Initial statements of purpose in the McKinsey Report and the first Handbook strongly asserted the importance of emphasizing general business practices. The current articulation of the philosophy of market conduct surveillance reflects this view, yet a sizeable minority of Chief Examiners (CEs) and Examiners in Charge (EICs) surveyed had a different view. Some regulators noted that isolated violations or errors warrant detection and correction. Some survey respondents indicated that the purpose of market conduct exams was to determine compliance with the law and regulations. However, we believe that compliance with the law should not be viewed as an end in itself, but as a means of achieving fair treatment of policyholders and claimants and achieving the maximum benefits of a competitive market. Thus, any effort to improve the market conduct system must be grounded in a clear definition and common understanding of the system's purpose.

2. Staff and Contract Examiners

- While the NAIC Handbook outlines the types of personnel that should be utilized in exams and examiner qualifications, considerable questions have been raised about the use of "contract examiners", their relative cost, suitability and effect on the intensity and performance of regulatory activities.

- Our survey indicated that 13 states utilize contract examiners, with a variety of reasons being offered by CEs for their use, such as an insufficient number of staff examiners, a lack of expertise within the department, and workload demands. Insurers did not perceive a marked difference in the qualifications and competency of contract vs. staff examiners.

- The use of contract market conduct examiners has evoked some controversy, as it did with financial examiners many years ago. Like the use of other contract staff and consultants, their effects on regulatory efficiency could depend greatly on how they are used and funded. It is not apparent that the use of contract examiners causes any significant pervasive problems or reflect a fundamental weakness of the current system. However, our Phase I report did note that the ability to bill the fees of contract examiners to the insurers being examined allows regulators to expand market conduct activities without obtaining funding approval from the legislature.

- Approximately 50 percent of the states responding to the survey do not use staff classifications listed in the NAIC Handbook. A significant number of staff market conduct examiners do not meet the qualifications outlined in the Handbook.

- Acquiring and retaining qualified market conduct staff will continue to be a goal and challenge, but it is not evident from our surveys that any perceived deficiencies in this area have had a substantial negative effect on the quality or efficiency of examinations. This observation stems from the responses of regulator and insurer survey respondents, most of whom did not indicate that examiner competency was a significant problem. This observation should not be used to undervalue the importance of proper and continued training, especially that warranted by changes to the current system.

3. Triggering and Frequency of Examinations

- There appear to be different views on the relative emphasis that should be placed on routine versus targeted examinations. The argument for conducting routine exams might be that other sources of information, such as complaint data and targeted exams, are insufficient to police market practices and detect all significant violations. The concern of insurers is that many routine exams are unnecessary and impose excessive costs.

- It appears that the majority of market conduct exams are targeted and their relative number is increasing over time. This may be due, in part, to recent market conduct problems, as well as a growing regulatory philosophy of using scarce resources in a more directed manner.

- Chief Examiners indicated that complaint analysis was the most frequent trigger for performing a market conduct exam. Chief Examiners also indicated that either they or the Commissioners were the primary decision makers in determining which insurers undergo a targeted market conduct exam.

- Insurers believe that there is a duplication of effort and a lack of coordination in exams of multi-state insurers, which is backed up by other information on this issue. In contrast, the states greatly coordinate the financial exams of insurers through the NAIC Zone Examination System. A factor impeding coordination of market conduct exams may be the lack of consensus on the purpose of market conduct surveillance.

- Interestingly, 25 percent of the state departments surveyed use "testing" methods that involve department staff or others who pose as consumers. This alternative means of detecting market conduct violations appears to be more widespread than we anticipated.

- The differing opinions on whether multiple states with different laws can rely on a common coordinated exam likely contribute to the lack of coordination and duplicative examinations of insurers.

4. Examination Preparation and Communication

- While surveys indicated that examiners almost always prepare a work plan and budget, they were not shared with insurers 42 percent of the time, and the time budget was not shared 67 percent of the time.

- The NAIC maintains an Examination Tracking System (ETS) on both financial and market conduct exams, but its use for the latter appears to be less than desirable. Only 32 percent and 46 percent of the CE's and EIC's, respectively, responded that they always use the NAIC ETS. Forty-three percent and 38 percent of the CE and EIC's, respectively, indicated that they never use ETS. Some examiners may perceive that ETS is less useful for market conduct exams (than financial exams) if they perceive that state coordination and communication is less valuable for market conduct exams.

5. Scope and Efficiency of Examinations

- The scope of exams has been a particularly significant issue, at least with insurers. Insurers have expressed a concern that the scope of exams is too broad and ventures into areas that do not require or are not suitable for regulatory reviews. Regulators may have a different view. However, this is not just a matter of the burdens placed on insurers. If surveillance activities are not properly focused, it will hurt regulatory effectiveness.

- While our survey showed almost all state departments use computer applications on market conduct exams, insurers are split almost 50/50 on whether this has made the exam process more efficient over the last three years. An important unresolved issue is whether undertaking a complete census of all insurer transactions is preferable to the more traditional auditing approach of using statistical sampling. Also, a relatively recent development is the use of desk audits in lieu of on-site exams. A number of examiners indicated a desire for increased access to and training in automated exam technology.

6. Use of Insurer Compliance and Self-Assessment Activities

- As a result of class action lawsuits and regulatory sanctions concerning sales abuses and other market practices, insurers have sought to improve their compliance activities and the treatment of policyholders. These initiatives include the Insurance Marketplace Standards Association (IMSA) certification, insurer formalization of internal standards and procedures, and self-monitoring. Insurers are employing a number of methods to assess compliance and policyholder satisfaction through self-assessment or independent assessment by an external firm. About 85 percent of the insurers surveyed responded that they performed self-critical analysis or retained independent assessors (permanently or regularly) to detect improper market conduct practices.

- There are at least two potential benefits to promoting insurer self-assessment activities. One is to improve insurers' market conduct compliance and decrease the number of violations. The second could be reducing the scope or extent of regulatory examinations and a more efficient use of regulatory resources. At this time, it appears that self-assessment activities often do not produce the second potential effect. This reduces insurers' incentives for self-assessment activities, diminishing their beneficial effect on market practices.

- More than 60 percent of the CEs indicate that insurers' self-assessment activities such as internal audit and compliance reviews by outside experts would not influence the scope of their market conduct examination. More than 75 percent of the CEs indicated that an IMSA certification would not influence the scope of their market conduct examination. These responses were confirmed by the fact that 60 percent of the insurers surveyed indicated that they believed that their self-assessment activities had little or no effect on the extent of their market conduct examinations. Furthermore, approximately 13 percent of insurers believe that their self-assessment efforts would expand the scope of market conduct examinations.

- These findings raise some interesting implications. Presumably, insurer efforts to improve their market conduct are desirable. Such efforts provide opportunities to modify examination processes to make more efficient use of regulatory resources. The current regulatory view of insurer self-assessment discourages self-assessment, with negative effects on the treatment of consumers.

7. Cost of Examinations

- The costs of the market conduct examinations, including direct and indirect cost to insurers, is a matter of concern to both the industry and state governments. These costs are ultimately passed to taxpayers and insurance consumers, so there is a public interest in avoiding costs that exceed the benefits of surveillance and compliance activities. Excessive costs could arise in two ways: 1) the inefficient performance of warranted regulatory tasks; and 2) the performance of unwarranted regulatory tasks.

- Unfortunately, it is difficult to accurately measure the costs of market conduct surveillance, especially indirect costs. It is even more difficult to quantify the benefits of market conduct regulation. Hence, a meaningful cost-benefit assessment was beyond the scope of our first report.

- It was interesting to note that when we asked insurers to compare the total direct costs of market conduct examinations to that of financial examinations over the last five years, almost 20 percent of insurers indicated that market conduct examinations produced higher costs. This finding is of interest because as a general rule, financial examinations take longer to conduct.

- The varying responses to the questions on market conduct examinations costs may stem, in part from differences in the scope and performance of examinations. We should also recognize that the cost of an examination could be affected by the size of the insurer being examined and the scope of its operations.

8. Enforcement Actions

- Enforcement actions refer to fines, penalties and other sanctions or orders that may be imposed as a result of market conduct examination findings. These findings may include instances of non-compliance with laws and regulations, as well as errors that range from random human mistakes to systematic errors that result from misinterpretation of coverages or procedural/system flaws.
- One of the interesting findings disclosed by our survey of insurance departments was that approximately one-third of the responding insurance departments did not have an established, specific policy for determining penalties for market conduct violations.

C. Market Conduct Surveillance is at a "Cross-roads" with No Clear Vision to Its Purpose

The findings of our Phase I Report, along with the testimony submitted before the Board of Directors of the Insurance Legislators Foundation on July 12, 2001, and the resulting dialogue amongst regulators, industry representatives, and state legislators has provided the ILF with a thorough understanding of the problems existing in the market conduct surveillance system in the U.S. Indeed, the ILF's interest in this subject and our report has stimulated the ideas and discussion that is currently occurring with respect to market conduct surveillance within the NAIC and the insurance industry - all are searching for ways to make market conduct surveillance efficient and cost-effective in today's environment.

Representative Michael Oxley of Ohio, Chairman of the House Financial Services Committee, identified market conduct examination reform as a priority for 2002. While his committee lacks direct jurisdiction to cause such changes, the increased Congressional attention underscores the need to transform the present system.

The ILF believes that our first report established a context for further study of market conduct activities, setting forth some very specific thoughts on what should be done next. Together, we viewed our study as the first stage in a multi-stage process of study, discussion, recommendation, consensus building, reformation and implementation to improve insurance market conduct surveillance.

While our first report represented an important initial step in facilitating a constructive public discussion of a critical insurance regulatory function, the Directors of the ILF now believe that further dialogue and effective action among various stakeholders is absolutely essential in promoting the realization of an efficient and effective market conduct system that will maintain public confidence.

The primary goal of Phase II of our analysis is to assist legislators and regulators in developing a coherent and efficient market conduct regulatory system. Market conduct surveillance is at a "cross-roads," much like financial surveillance was when McKinsey and Company was hired in the early 1970's to conduct a comprehensive study and to offer recommendations for changes to that system. There is an ever-increasing urgency to respond to the criticisms of the “objectives” and the "process" of market surveillance, criticisms which focus mainly on questions of orientation, value, timeliness, cost, and the protection of consumer interests. The "engineering" analysis of market conduct surveillance presented here deals not merely with particular problems or criticisms, but re-evaluates the very fundamental question of purpose and scope of market conduct surveillance.

The “what” and “why” of market conduct regulation and surveillance are as important, if not more important, than the “how.” As we discuss below, the areas and practices subject to regulatory surveillance must be carefully considered and defined according to sound economic and regulatory principles. If regulatory surveillance is misdirected, it cripples the overall system and will adversely affect market outcomes and consumer welfare. Further, regulatory objectives will necessarily influence the specific activities of regulators and the strategies and processes best suited to achieve these objectives. In other words, the “what” of market conduct regulation should precede the “how.” Further, determining what requires regulatory attention involves questions of why certain market problems arise and why regulation is the best remedy for these problems. Unfortunately, the objectives of market conduct regulation seem to have become lost in the recent public discussions of how regulatory processes should be changed.

D. MARKET CONDUCT REFORMS MUST FIT INTO AN EFFICIENT REGULATORY SCHEME

To build on our prior study, in this report we develop a conceptual framework for market conduct surveillance for which specific procedures and public policy can be crafted. Any reform effort must be based on a well-defined purpose for doing market conduct exams. It also must be fashioned to fit into an efficient regulatory scheme. An efficient regulatory scheme should be founded on sound economic principles and encourage the commitment of capital, promote competition, provide stable insurance markets, enhance consumer choices, and produce other public benefits expected in a competitive market.

As we noted in our Phase I Report, there has been no comprehensive review of the market conduct surveillance system since the McKinsey & Company study in the early 1970s, when McKinsey recommended that market conduct surveillance be separated from financial surveillance. While McKinsey laid the foundation for an effective market conduct system at that time, actual practices have diverged considerably from the original vision. Market conduct has become an extremely parochial regulatory practice from state to state, with widely varying practices that appear to be more a matter of taste than necessity. There is a need to move to a rational, coordinated system based on a common model with some flexibility to address state-specific needs when this is necessary.

E. EVOLUTION OF INSURANCE MARKETS

The evolution of insurance markets in the U.S. is an important consideration in revamping the system for market conduct regulation. Insurance markets have changed since market conduct regulation was established in the 1970s. Consumer information has increased but insurance products also have become more varied and complex in certain lines. In our previous report, we reviewed general industry developments and their implications for our evaluation of the existing regulatory system. In this report, we summarize the highlights of our previous review and present additional discussion on changes in specific markets with significant implications for improving the framework for market conduct regulation.

1. General Industry Developments

The insurance industry in the U.S. has continued to evolve since its beginnings in the late 1600s, but the changes within the last 50 years have been particularly dramatic (Klein, 1995 and 1999). The industry has grown faster than the overall economy and a number of new insurance products have been introduced. The number of insurance companies also has increased substantially and alternative types of risk-bearing entities have emerged. Companies of various sizes selling a vast array of products across state and national boundaries populate the industry. Fierce competition among and between insurers and other financial institutions is redefining insurance and financial services markets. Advances in information technology and digital commerce have begun to affect many industry functions, particularly distribution and underwriting. The evolution of the industry has significant implications for all aspects of regulation, including market conduct.

The rapid growth of the private insurance industry in the U.S. is reflected in Exhibit I-1, which plots industry income (premiums and investment income), in constant dollars, relative to gross domestic product (GDP) over the period 1960 to 2000. Total industry income increased from $225.3 billion (measured in 2000 dollars) in 1960 to $1.2 trillion in 2000, a 417.9 percent rise in real terms. Insurance income represented approximately 11.8 percent of GDP in 2000 compared to 8 percent in 1960.[1] Industry growth is further reflected in the rise in industry employment from 2,090,000 in 1989 to 2,346,000 in 2000 (Bureau of Labor Statistics, 2001). It is reasonable to surmise that the number of insurance transactions has increased dramatically. We previously presented data that indicate that average household expenditures on insurance also have increased in both nominal and real (inflation-adjusted) terms. Insurance has become a more important and salient component of the U.S. economy. This reflects the relationship between risk management and highly developed economies (Skipper, 1998).

[1] The comparison of industry income with GDP should be qualified because the quantities are defined differently. Industry income essentially reflects all revenues flowing through the industry, while GDP only reflects the value added by each industry. Hence, the value added by the insurance industry, i.e., the value of the actual services provided by the insurance industry, is less than its revenues, which include funds to pay claims. However, the comparison does provide a crude indicator of the relative growth of insurance in terms of its management of resources.

The number of insurance companies continually increased until the mid-1990s (Insurance Information Institute, 2002; American Council of Life Insurance, 2001) when it began to drop due to fierce competition and the need to increase efficiency and consolidate capital.[2] Consequently, the average size (measured by assets or revenues) of an insurer has increased in real terms. This has several implications for the market conduct regulatory framework. On one side, there are fewer insurers to regulate, which should enable regulators to direct their oversight more efficiently. On the other side, competitive pressures to cut costs and increase profitability could result in more market conduct issues. Also, if a large insurer engages in unlawful/unfair market practices, a large number of consumers may be affected. This underscores the need for a more focused regulatory approach with regulators becoming more familiar with each insurer's specific products and activities.

Several other general industry developments deserve mention. One such development has been the move towards financial convergence, aided by federal legislation, with insurance and non-insurance financial institutions increasing their involvement in each other's traditional markets. One consequence of this is that new players, such as banks, are entering insurance markets in a more substantial way. Also, some firms are seeking to leverage economies of scope by providing an array of insurance and non-insurance financial services to consumers.

Under the functional regulatory scheme approved by Congress, insurance regulators are responsible for regulating the insurance activities of non-insurance financial institutions. Insurance regulators may encounter a different culture towards market practices in the new entrants and will need to coordinate with the principal regulators of these firms. Important market conduct issues include the sharing and use of customer information and the joint marketing of various financial products and services.

Indeed, the rapid advance of information technology and data analysis has conduct implications in the areas of marketing and underwriting. Firms are using data to more selectively target consumers who will be most receptive to their products. At the same time, insurers are using

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[2] This estimate of the number of insurance companies may be somewhat conservative and does not include non-traditional insurers.

data in innovative ways to improve risk classification and pricing, such as credit scoring in assessing auto and home insurance risks. Soon we may see insurers use optimal pricing methods to attract buyers much like several other industries do. Legislators and regulators need to reconsider their views on the use of new information and methods and articulate policies that will not discourage efficiency-enhancing innovations.

Another important development is the evolution of insurance distribution systems. The predicted extinction of the independent agent appears somewhat premature but changes are occurring. Clearly, agents' role as simple processors of insurance transactions is diminishing and their role as insurance and financial advisors is increasing. Market conduct regulators will need to assess their approach towards the multiple roles of intermediaries and potential conflicts of interest that may arise with the coupling of insurance sales and financial advice.

The contribution of the Internet and electronic commerce to insurance is developing slowly. It appears that many consumers find the Web to be a good source of information on insurance products but few transactions are accomplished electronically. The primary issue for market conduct regulators is solicitation by non-licensed insurers and the difficulty in enforcing state regulations in an electronic marketplace. The states and the industry have moved quickly in addressing the regulatory issues and the slow development of insurance electronic commerce may permit regulators to keep pace with any problems that arise. Still, from a long-term perspective, the ultimate implications of electronic commerce in financial services may compel a new paradigm on how to regulate insurance markets.

Market conduct issues vary by industry segment. The need for regulatory protection is greatest for individual consumers and households. Similarly, regulatory oversight is more intense for insurance purchased by small businesses and declines with the size of the buyer. Even in the more heavily regulated lines, the type of product also makes a difference. More complex products sold to individual consumers (e.g., universal life policies) tend to generate more market conduct problems than simple products (e.g., term life insurance). Below, we discuss significant developments in key market segments.

2. Personal Property-Liability Lines

The principal personal property-casualty lines are auto and home insurance, which account for approximately 50 percent of all property-casualty premiums. Personal consumers also purchase umbrella liability insurance and inland marine insurance, among certain other specialty lines. Personal auto and home insurance is a major area for market conduct regulation because of the premise that individuals and households require greater regulatory protection than firms and the public importance attached to these coverages.

In our previous report, we demonstrated the strong competitiveness of personal auto and home insurance markets. In the early 1970s, homeowners multi-peril policies were growing, but separate dwelling fire and allied lines coverages constituted a significant portion of the market. Since that time, relatively standardized homeowners multi-peril policies have essentially replaced the older dwelling policy forms in which consumers make a number of choices with respect to the coverages they would purchase. Private passenger auto policies, combining a typical set of coverages, also have become relatively standardized. Consequently, consumer choice has focused on price, the quality of the insurer, and important policy options such as coverage limits and deductibles. Arguably, the standardization of these products has lessened the potential for marketing-associated problems, e.g., product misrepresentation. Further, increased consumer access to information enhances the ability of market forces to discipline insurers that might attempt to engage in abusive practices.

Since our first report, the supply of auto and home insurance has tightened. Underwriting has become stricter and rates are increasing. Some of this was predictable, as rates had fallen below sustainable levels due to fierce competition amidst rising costs. However, certain recent events, including the overall industry impact of terrorism losses and risk, the decline of the stock market, and mold claims in home insurance, appear to be further contributing to market tightening. Natural perils also continue to cause concerns. In addition to their impact on underwriting and rates, these developments have prompted some modifications of policy options available to consumers, e.g., larger deductibles and windstorm exclusions.

From a long-term perspective, the underlying competitiveness of auto and home insurance markets obviates the need for regulators to address problems that would be created by a lack of competition. Also, the wide availability of auto and home insurance, even with recent events, suggests that the marketing and underwriting practices of a particular insurer does not preclude a consumer from finding competitively priced insurance. We would argue that consumers have more information available to them and means of access to insurance today than they did three decades ago. However, competition does not preclude certain insurers (unconcerned about reputational effects) from attempting to take unfair advantage of a consumer, particularly in the adjustment and payment of claims. This is where market conduct surveillance might be best focused.

3. Commercial Property-Liability Lines

Commercial property-liability insurance markets are characterized by buyers of widely varying size and sophistication. Generally, the need for regulatory protection diminishes with the size and sophistication of the buyer. This is reflected in recent movements to revamp the regulatory structure for large commercial insurance buyers. We focus our attention on market conduct issues for smaller buyers.

As in the personal lines, packaged commercial multi-peril policies have become predominant for small and medium-size firms, e.g., Business Owners Policies (BOPs). Standardized policy forms and coverage options work well for some firms with typical insurance needs. Marketing abuses should be less of a concern for these products. At the same time, even some small firms have needs for specialized coverages and may utilize surplus lines carriers. Also, some small firms may seek or be solicited by non-licensed insurers and alternative risk bearing entities. Regulators need to determine what types of potential conduct problems in these markets warrant their attention.[3]

[3] For example, following the 1992 civil disturbance in Los Angeles, many affected small business owners had purchased insurance from non-admitted, non-U.S. insurers. Some of these owners experienced problems in collecting on claims with some of these insurers. This raised issues with respect to the marketing and distribution activities of offshore insurers in California.

Like personal property-liability insurance, commercial property-liability insurance is structurally competitive. Indeed, commercial insurance is subject to chronic "soft-market" conditions that inevitably require insurers to tighten their underwriting and raise prices to sustainable levels. We are currently experiencing such a market tightening, exacerbated by increased terrorism risk, lower asset values, adverse liability trends and other factors. The cyclical nature of the industry is a concern to everyone, but it is ill suited to coercive regulatory remedies. Voluntary Market Assistance Plans (MAPs) and reforms aimed at mitigating cost drivers appear to be the best way to help commercial buyers during these temporary market dislocations.[4]

Small firms and individual entrepreneurs continue to play a dynamic role in certain sectors of the economy. Hence, the value of insurance and market conduct regulation to these buyers is not likely to wither away. Some small firms may be positioned to hire insurance advisors and make use of brokers, which should help protect them from deceptive and abusive practices in the purchase of insurance. However, it may not be economically feasible or efficient for other small firms to hire advisors. Given the complexity and variation of certain commercial insurance policies, market conduct regulators may need to focus some resources on the marketing of commercial insurance to small buyers, as well as claims processing.

4. Health and Disability Insurance

Market conduct issues in the health and disability insurance sector are somewhat unique, as most individuals and families have health insurance through group plans, typically sponsored by their employer. Historically, Blue-Cross Blue-Shield plans and "traditional" indemnity insurers dominated the market. The "Blues" were subject to special and intensive regulation due to their unique public charter. The lack of severe competitive and cost pressures probably lessened the frequency of market conduct problems, such as disputes over claims.

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[4] In a market assistance plan, regulators recruit insurers willing to offer coverage and match them with insureds looking for coverage. This type of program facilitates the role of market forces in restoring a market hit by a loss shock and the tightening of the supply of insurance.

This scenario has been overturned by the managed care revolution and the rapid growth of Health Maintenance Organizations (HMOs) and Preferred Provider Organizations (PPOs), along with the recent emergence of Provider Service Organizations (PSOs). Also, hospital-surgical expense policies, more common in the 1970s, have been largely replaced by major medical insurance policies. Because of rapidly rising costs, competition among the Blues, insurance companies and alternative entities has become fierce. The consequences of market pressures, in turn, have increased market conduct issues and consumer complaints.

Self-funded employer plans also have become more prominent, which are essentially outside the purview of state insurance regulation because of ERISA preemptions. Group and individual health insurance purchases from licensed insurance companies do fall within insurance regulators' jurisdiction, although the involvement of a third-party group contract holder and payer (e.g., an employer) may complicate market conduct regulation. Clearly, there are salient issues with respect to pricing, underwriting, claims and quality of care that have received significant public attention and involved legislators and regulators. Policymakers have focused particularly on the underwriting and pricing of small groups and individuals and claims handling and quality of service in managed care. The locus of regulatory authority over HMOs varies among the states, but it appears that the trend has been to increase insurance regulators' oversight of HMOs. Specialty lines such as Medicare supplement insurance, limited coverage health policies, and long-term care insurance also have been the subject of special regulatory attention. Recently, disease-specific policies appear to be experiencing resurgence. Regulatory activities in health insurance markets have increased and will likely continue to grow.

5. Life Insurance and Annuities

For many years, life insurers' bread and butter were standard term and whole life policies that emphasized death benefits and offered a savings component with low but guaranteed returns (for whole life policies). The current environment is much different, as life insurers now offer an expansive menu of life insurance policies, annuities and other interest-sensitive contracts with different risk-return characteristics. Exhibit I-2 reveals the increasing significance of more complex products in the life insurance sector.

Market conduct problems in life insurance took center stage in the mid-1990s and have significantly influenced market conduct regulation. The principal concerns have involved misrepresentations and improper replacements of policies that became apparent as interest rates dropped and the policies failed to deliver the returns that policyholders had expected. As several major class action lawsuits were filed against large insurers, the industry and regulators awakened to the huge problem that had developed. This prompted both regulatory actions and industry and insurer self-regulation initiatives to curb the abuses and restore consumer confidence in the industry. Policy representations, replacement and "suitability" are difficult to regulate and the crafting of new regulations in these areas has been highly contentious. The life insurance and annuity sector will draw increasing regulatory attention and present challenging tasks to regulators.

F. DEFINITION OF TERMS

It is helpful to define several key terms used throughout this report, clarifying what we mean by these terms and what we think most regulators believe them to be. In essence, these terms represent increasingly specific aspects of regulators' policing of insurers' and agents' market practices. Exhibit I-3 presents a schematic diagram of the structure of market conduct regulation functions.

A good place to start is the term "**market conduct.**" Economists have a certain understanding of what constitutes market conduct that may differ somewhat from how it is viewed by insurance regulators and the industry.[5] Commonly, market conduct is understood to encompass insurers' and agents' market practices that involve interactions with consumers or insurers. The following activities might fall within this area:

- Marketing, advertising and product representations
- Sales

[5] Economists are primarily concerned about anti-competitive firm conduct, whereas insurance regulators are primarily concerned about trade practices that take unfair advantage of consumers.

- Underwriting and pricing
- Issuance of insurance policies
- Collection of premiums
- Policy renewals, terminations and refunds
- Dividend payments to policyholders
- Policy changes
- Claims settlement and payment

New regulatory responsibilities in monitoring managed care practices in health insurance could be added to this list, e.g., pre-authorization of medical services. Regulators should be most concerned about "unfair" industry practices or actions that have substantial adverse effects on consumers', policyholders and claimants/beneficiaries. Note: there is a distinction between practices or actions that are clear violations of state laws and regulation and those practices and actions that might be viewed as unfair or unreasonable by regulators, but are not necessarily legal violations per se. There has been a continuing debate on whether and how market conduct regulation should address the second area.

The types of practices that regulators have viewed negatively and/or in violation of state laws and regulations include:

- Misrepresentation of insurance products
- Excessive sales pressure
- Fraud
- Sale of unsuitable products
- Replacement of policies that is not in the best interest of the consumers
- Inappropriate risk classification
- Rejection of insurance applications not based on "acceptable" underwriting criteria
- Sale of policies not approved by regulators' and/or in violation of state laws and
- Premium calculations inconsistent with filed rates
- Prices that are excessive or unfairly discriminatory
- Improper terminations; failure to provide adequate notice of terminations

- Failure to refund premiums or dividends due to insureds
- Failure to pay legitimate claims, underpayment of claims and unreasonable delays in paying claims.

Some regulators might add anti-competitive practices to this list. Of course, regulator and insurer views may differ as to legality or fairness of a particular practice or action.

Market conduct regulation is the broadest term that characterizes regulators' authorities and activities with respect to insurer market practices. Hence, it encompasses: 1) all laws, regulations and other standards that pertain to insurers' market practices; 2) regulators' monitoring of insurers' market practices and identification of violations and problems; and 3) regulatory enforcement actions. Some regulators also might argue that market conduct encompasses the regulation of rates and policy forms.

Market conduct surveillance primarily refers to Item 2 in Exhibit I-3, regulatory monitoring. **Market conduct examinations** are an important component of market conduct surveillance, which also includes: complaint monitoring, analysis and response; market conduct "desk exams"; "testing"; and other methods of gathering information about insurers' market practices. While market conduct examinations were the primary focus of our first report, they must be evaluated in the context of market conduct regulation, surveillance and enforcement actions, which influence or result from examinations. In this report, we present a framework for market conduct surveillance and certain other aspects of market regulation, which includes but is not limited to examinations.

II. INTRODUCTION AND OVERVIEW

A. MARKET CONDUCT REGULATION AND EXAMINATION MUST EVOLVE CONSISTENT WITH MARKET CHANGES AND THE DEVELOPMENT OF REGULATORY AND COMMERCIAL INSTITUTIONS

Our Phase I study revealed that while there are many positive aspects of the current market conduct surveillance system, a wide range of disparate views, policies and practices remain. Clearly, among the issues and concerns that resonate most strongly from our surveys of regulators and insurers are ones that involve the purpose and objectives of market conduct examinations. Indeed, these issues have significant implications for many of the process issues that also arose from our initial study. The appropriate philosophy and scope of market conduct examinations, and the objectives that naturally follow, will be the focus of this Part I of our Phase II Study.

Since our Phase I report, a number of ideas for improving market conduct surveillance have been put forth. These will be summarized later in this report. While we commend the efforts to propose changes, for reform to succeed there must be consensus on a clear vision of what needs to be regulated and why.

Answering the "the what" question is tied with answering "the why" question. Further, procedural reforms must commence with the development of a coherent and well thought out statement of concepts and principles. In our view, one of the obstacles to achieving significant improvements in this very important regulatory function has been the vagueness about what the system is supposed to accomplish.

This report advocates a transformation of market conduct surveillance – not "ad hoc" incremental changes, but a rethinking of the purpose of market conduct surveillance in today's environment. This transformation must be done within a regulatory system that will best serve consumers, prioritize the use of regulatory resources and conform to economic principles of regulation. Therefore, our recommendations will not just state a conceptual framework for market conduct examinations, but will do so within the context of a market conduct regulatory system that we believe will best serve consumers and the general public.

It is clear from our earlier work that, in part, the different policies and practices a state employs in conducting market conduct surveillance result from the nature of the regulatory system that the state has in place. For example, a state that requires prior approval of rates will want to determine if only approved rates are used.[6] Our inquiry cannot be limited to just determining the propriety of this particular activity. Rather, our inquiry must also address the rationale for and implications of the regulation of insurers' products and prices. These and other fundamental regulatory questions will be discussed later in this report as we develop the conceptual framework. We believe that this is a critical component of reforming market conduct surveillance. Of course, there are other considerations.

The road to establishing a proper and definitive purpose and objective for market conduct surveillance must also include a basic assessment of the current system. While we address this subject in some detail later, stated directly and simply, it is time for the system to mature. Insurance markets have evolved, we have accumulated 30 years of experience in regulating market conduct, and we can draw insights from other areas of regulation. In part, this means that each state must recognize that it is and must be a part of a national system of regulation. There are other elements to this maturation, but we will focus on this element at the moment.

Long ago, the states effectively embarked on developing a national system for the regulation of insurers' financial condition that is focused, standardized and streamlined.[7] The goal of financial regulation is to limit the risk that insurers will default on their contractual obligations to

[6] Of course, even under "competitive rating" systems (e.g., file and use, use and file, etc.) regulators may believe it is important to verify that consumers are charged the rates that have been filed. However, the regulatory importance attached to "rate checking" and the potential for discrepancies may increase with the stringency of regulatory rate constraints.

[7] Several important initiatives during the late 1980s and throughout the 1990s further strengthened this system. These initiatives include: 1) financial regulation standards and accreditation; 2) risk-based capital; 3) development of new monitoring tools; 4) enhanced data reporting and electronic access to data; 5) formation of the NAIC's Financial Analysis Working Group; 6) codification of statutory accounting principles (SAP); and 7) new and revised model laws and regulations, among other initiatives. See Klein (1995, 1999, and 2002) for further discussion of some of these initiatives.

policyholders. This goal is pursued through enforcing financial standards, monitoring insurers' financial condition, and intervening with companies in hazardous condition. The system relies principally on the domiciliary state to undertake these responsibilities, in coordination with other states in which an insurer writes business. Non-domiciliary states provide a "check and balance" on the regulatory performance of the domiciliary state – if the domiciliary state fails to take necessary actions, other affected states will intervene to protect the interests of their resident policyholders. Hence, there is a commitment to coordinated policies and action that reflects the states' mutual interests in regulating the financial condition of insurers. This commitment is driven by the need for efficiency as well as the protection of common interests.

The system employs a number of devices that are uniform or closely similar from state to state, e.g., the annual statement blank, accounting principles and procedures, the valuation of securities, etc. Examinations and other regulatory activities are closely coordinated not just by established procedures, but by chief financial examiners who understand that such a process is essential to having a regulatory system that is efficient and effective.

The procedures employed by regulators that oversee insurers' financial condition differ substantially from those employed for market conduct regulation. Traditionally, many state regulators have viewed the market conduct system as more specific and local. The reasons for this include the mindset that each state is somewhat autonomous in regulating its insurance markets and the existence of state-specific laws and regulations governing insurers' products, prices and practices. One growing problem with the parochial nature of market conduct regulation is that excessive regulatory burdens imposed in one state impair an insurer's ability to serve consumers in other states. This problem is becoming more severe as insurers' interstate operations increase and compete with other financial service firms. Further, it is not apparent that the market conduct protection needs of consumers differ substantially across the states. State regulatory differences appear to arise more from politics and bureaucratic preferences. Resolving this issue will be essential to establishing a consensus on the purpose, objectives and scope of an efficient market regulatory system.

Another aspect of the maturation of the market conduct surveillance system is a recognition that marketplace changes have occurred and will continue to occur in the future. Therefore, procedures and practices must continually evolve. For example, today more than ever, well-run companies devote attention to compliance matters and fair treatment of policyholders. Retention of policyholders is viewed as critical to a company's success. Reputational risk is an important aspect of most company's risk management programs, yet as our Phase I study observed, these activities are largely ignored by the current regulatory system.

The market conduct surveillance system should not only take account of a company's compliance efforts and self-critical analysis programs, but also seek to incentize and reward companies that do so. Regulators should be offering guidance to companies on how to conduct such programs to meet regulatory standards and avoid duplicative regulatory audits. Regulators should encourage companies to have a corporate culture that emphasizes compliance and fair treatment of policyholders as matter of policy and priority that is in the best interest of the company. Corporate culture determines how an organization behaves when not being watched. [8] Such culture is established by the 'tone at top' that influences the behavior expected throughout the organization. Companies that have robust compliance programs and a healthy, pro-consumer corporate culture are less likely to present significant market conduct problems and regulators must recognize this reality.

B. BRIEF HISTORICAL REVIEW

History reflects the rationale and evolution of insurance market conduct surveillance and is useful in evaluating current practices. Thus, a brief historical review is included here, focusing on key developments and the important issues that have been debated as the market conduct surveillance system has evolved. This discussion will reveal that the reasons **why** decisions were made are as important as the decisions themselves. This review also includes a discussion of the primary market conduct reform initiatives set forth by the NAIC's Market Conduct and Consumer Affairs (D) Committee since 2000 and industry comments on these initiatives.

[8] This concept was developed by Tom Tierney, former managing partner of BAIN, a consulting firm, and author of "Aligning the Stars."

1. The McKinsey Study

Our historical review begins with the McKinsey Study of 1974 that evaluated and made recommendations concerning both financial and market conduct surveillance and set forth several progressive and farsighted ideas. While the McKinsey study focused primarily on financial surveillance, its attention to market conduct reflected the increasing recognition of the importance of this function. It also reflected a philosophy that an insurer's financial condition and market conduct were intertwined, and that problems in one area might indicate problems in the other. Additionally, there was a desire that, as market conduct regulatory activities expanded, these activities would be conducted in an effective and efficient manner. Today, nearly thirty years later, these ideas continue to be endorsed, yet have not been fully realized. This is apparent as we compare the development of actual regulatory market conduct practices with the "vision" found in the McKinsey Report and related NAIC documents.

McKinsey recommended that financial surveillance be separated from market conduct surveillance.[9] In McKinsey's view, the former should concern itself with determination of financial condition and the latter should focus on the treatment of policyholders. The McKinsey report states that the purpose of market conduct surveillance is to "protect policyholders and claimants against unfair market practices." The report articulated a philosophy that continues to be reflected somewhat in the current Handbook. The philosophy is that market conduct surveillance should be focused on companies that are engaging in unfair business practices, rather than those insurers that infrequently and unintentionally make errors in serving consumers. This implies that regulators should focus on a pattern of unfair practices or actions, rather than inadvertent and occasional mistakes. Such patterns are to be identified by a high frequency of improper actions or their origin in a company policy or procedure. McKinsey recommended that unfair practices be detected through complaints, the review of company materials, examination of specific transactions, and interviews of agents and company personnel.

[9] The view on a separate market conduct function should not be interpreted as being at odds with the opinion that financial and market regulatory functions are interconnected. Rather, McKinsey's point was that market conduct deserved focused attention resources and not be treated as a min sub-area of a financial examination.

McKinsey further advised that market conduct specialists should be used for market conduct surveillance rather than delegating this responsibility among staff members who lack the necessary expertise. This remains an interesting question today, as some insurance departments have no separate market conduct units. In fact, in the early years of market conduct surveillance, many states placed this responsibility under the control of the financial Chief Examiner.

McKinsey identified three elements of an effective market conduct surveillance system: 1) a complaint analysis system that targets problem companies and lines; 2) a system for scheduling targeted field exams; and 3) field exam procedures tailored to the scope of a company's operations and problems.

It is interesting to note that McKinsey did not recommend routine, comprehensive market conduct examinations. This contrasts with actual practice, as many states perform periodic routine, comprehensive exams in which regulators review a large number of company transactions, records and documents. The explanation may be that regulators believe routine exams are necessary because other detection methods are insufficient by themselves to find all market conduct violations. However, it is not clear that periodic, comprehensive examinations of all or most insurers uncover patterns of abusive practices that would justify the costs of such examinations for regulators and consumers.

McKinsey advised heavy reliance on a complaint analysis system to target problems and initiate exams, viewing complaint analysis as the counterpart to financial analysis in the area of financial surveillance. Today, many states, although not all, have developed complaint systems and participate in the NAIC complaint system. Also, the expansion of the data and information systems available to monitor market conduct may offer means to detect problems to supplement the use of complaints to uncover illegal or unfair trade practices.

While McKinsey recommended that exam results be documented in a timely action oriented report, our initial study revealed that the timeliness and content of exam reports continue to be of concern in the current system.

The importance of interstate cooperation in sharing information and coordinating field exams was recognized by McKinsey and is of even greater importance today. Unfortunately, we found that the lack of interstate cooperation, communication and coordination is a significant problem.

2. Impact of the McKinsey Study

Clearly, the McKinsey study played a major role in forming early NAIC opinions, documents and systems regarding market conduct surveillance. McKinsey's findings led to substantial work on the first Market Conduct Examiners Handbook. Since then, the Handbook has become an important and valuable reference in presenting collective regulatory views on best practices in market conduct surveillance.

The views of an industry advisory committee appointed to refine the first Handbook in 1975 reflect some of the issues and different opinions on how market conduct surveillance should be performed. The advisory committee consisted of representatives from insurance companies and trade associations, as well as academics. The advisory committee stressed the need for a "statement of philosophy" in the introduction of the Handbook to help guide examiners. Interestingly, contrary to McKinsey, the advisory committee recommended routine exams to avoid the presumption of unlawful activity that would be generated by targeted examinations. Insurer preferences with respect to routine versus targeted exams have since changed. Semantics also were important to the committee. For example, the advisory committee preferred the use of the word "unlawful" practices rather than "unfair" practices because it believed that the use of the latter would prompt regulators to make subjective judgements about company activities that should be a matter of insurer discretion.

The committee urged the need for cost efficiency, recognizing the exam costs assessed to insurers would be passed to consumers. The committee recommended against imposing numerous and rigid "industry norms" that would impede competition. It believed that company diversity should not be discouraged and that the presence of workable competition in a market should be a governing consideration. Importantly, the advisory committee stressed the need for due process and respect for an insurer's legal rights in the market conduct surveillance process.

The advisory committee also agreed that state market conduct surveillance activities and exams should be coordinated to the maximum extent possible. It affirmed reliance on zone exams, when feasible, and avoidance of duplicative or repetitive exams.

It is interesting to note that the advisory committee preferred less separation between financial and market conduct regulatory activities than that recommended by McKinsey. It recommended that both financial and market conduct exams be under the Chief Examiner.[10] The Advisory Committee further recommended that market conduct exams should only be triggered by alleged violations of law or unfair trade practices as defined by the applicable trade practices act. It suggested that when regulators had concerns about practices that they believed were inconsistent with the public interest, but not legal violations per se, that these issues be resolved through pre-exam conferences. Only if such informal measures failed, would an exam be conducted. The Advisory Committee also recommended against "market conduct norms" until further experience was acquired and research was performed. Industry concerns about the lack of objective, enforceable standards (e.g. interpretations of product suitability) continue through today. This is a complex issue, as insurers may dislike what they perceive to be overly rigid, arbitrary standards, as well as subjective regulatory evaluations of company practices. However, a preoccupation with law violations could result in too many resources devoted to minor infractions at the expense of serious market conduct problems that are not yet addressed by explicit laws and regulations.

Several states took an early lead in developing significant market conduct examination functions, including California, Illinois, Massachusetts, Missouri, and New York. Both the Illinois and Missouri Insurance Departments published reports that provide some glimpses of their views on the system for market conduct surveillance. It is reasonable to assume that the initiatives of particular states influenced NAIC recommendations and the systems developed by other states.

[10] We should note that a number of states do perform combined financial and market conduct examinations.

The evolution of market conduct surveillance has included the development of a professional certification program for examiners by the Insurance Regulatory Examiners Society (IRES) and information technology by the NAIC to support market conduct regulation.

The Handbook has gone through several revisions since its adoption, with a restatement of the philosophy of market conduct exams: In its most recent iteration it states that:

> "The examination can be most effective if it focuses on general business patterns or practices of an examinee. While not ignoring random errors, the market conduct examination should concentrate on an insurer's general practices."

While this statement reaffirms the basic philosophy that has guided NAIC recommendations on market conduct surveillance, it tempers the relative emphasis on company practices versus inadvertent errors advocated in the McKinsey Study and the first Handbook. It is interesting to note that compliance with laws and regulations is not part of this 'purpose' or the earlier version. Yet, our Phase I findings suggest that this activity is of paramount importance to many states.

While complaint analysis information continues to play a significant role, the current Handbook identifies fourteen sources of information for prioritizing exams, including information available from NAIC databases and computer applications. The NAIC's Examination Tracking System (ETS) provides an efficient but a greatly under-utilized tool for sharing information among states. The Handbook now contains a chapter on sampling as an important auditing tool, separate chapters for conducting exams of property-casualty, life and health insurers, and general standards that set the level of conduct that a company is expected to meet. While the content of market exam reports have been a continuing concern for insurers and some legislators, the Handbook now has a chapter on this topic that at least has the potential for promoting best practices in exam reports.

C. THE INSURANCE LEGISLATORS FOUNDATION'S MILESTONE PHASE I PUBLIC POLICY REVIEW AND THE NAIC'S REFORM INITIATIVES PROMPTS RECOMMENDATIONS FOR CHANGE

1. Market Conduct Reform Working Groups

In March 2000, the nation's insurance commissioners endorsed "The Statement of Intent – The Future of Insurance Regulation," pledging to examine the current focus, structure and implementation of market conduct programs in the states to identify the issues and concerns that currently exist in this area. This examination was to help determine the merits of industry uniform standards as a basis for market conduct exams and enforcement actions. However, the NAIC's Statement of Intent was not restricted to market conduct examinations. While the "Speed to Market" and "National Treatment of Companies" working groups have received considerable attention over the last few years, the Statement listed several other regulatory processes that the insurance commissioners determined could be made more uniform. The "Statement of Intent" included the following broad directive for market conduct reform:

> "Market conduct is an essential regulatory tool. Its importance to regulators, producers and consumers will increase as the "Speed to Market" reforms are implemented and the marketplace evolves. We will examine the current focus, structure and implementation of market conduct programs in the states to identify the issues and concerns that currently exist in this area. This examination will help us determine the merits of voluntary uniform national standards as a basis for market conduct examinations and enforcement actions. In pursuing this evaluation we will keep in mind the need for flexibility to allow local treatment of conditions produced by local markets."

During calendar year 2000, the Market Conduct Consumer Affairs (D) Committee prepared a Blueprint for the Modernization of Market Conduct Examinations, focusing on greater uniformity in exam procedures, the minimum resources necessary for an effective market conduct program, and the role of self-audits and self-reporting in market conduct oversight.

The Insurance Legislators Foundation's Phase I Study has served as a foundation for the (D) Committee's work on market conduct reform since 2000. The NAIC's efforts have been focused in four areas: 1) uniform exam procedures; 2) market analysis to better target companies and identify issues; 3) identification of necessary market conduct examination resources; and 4) coordination of activities among the states. In 2003, the Market Analysis Working Group and the Uniformity Working Group will coordinate all market reform initiatives. A brief discussion of the NAIC's key initiatives follows. The NAIC has performed considerable work in attempting to provide the guidance and various types of tools necessary to achieve thorough, uniform and comprehensive market regulation.

The Honorable Mike Pickens, NAIC President and Arkansas Insurance Commissioner has indicated that in 2003 the nation’s insurance commissioners are committed to streamlining and simplifying state insurance regulation while continuing to protect consumers. In 2003, the NAIC will emphasize even more consumer access to information, and even more communication among insurers, consumers and regulators, according to Mr. Pickens. Improving the efficiencies and effectiveness of market conduct is front and center on this year’s agenda.

2. A Brief Overview of the NAIC Four Market Regulatory Reform Initiatives

a. Uniformity in Exam Procedures

The Committee appointed a Market Conduct Uniformity Working Group in 2000 to identify the most important areas for uniformity in the exam process and to develop a plan that encourages states to adopt these uniform exam procedures, many of which already are contained in the Handbook. Regulators have now developed a set of "best practices" to bring more uniformity to the market conduct exam process and a self-certification program for states to indicate their compliance with the practices. In addition, a report card has been distributed for each state to identify its current degree of examination uniformity

The Uniformity Working Group will focus on the following three initiatives in 2003: 1) examination uniformity, 2) investigation standards, 3) the state reciprocity agreement and the appropriate baseline responsibility for the domestic regulator.

The NAIC's 2000 Blueprint recognized that self-audits by companies can also play an important role in effective market conduct oversight. The NAIC's view is that while such self-reporting is no substitute for active regulatory monitoring, it can supplement examinations and other regulatory tools by providing information regulators can use to identify problem areas and target resources where they are most needed. Some states have enacted laws providing insurers with a self-critical analysis privilege in order to encourage company self audits, though this issue remains controversial among regulators and consumer groups. Another related approach is to encourage voluntary industry accreditation programs, such as the National Committee on Quality Assurance (NCQA) for health insurers, and the Insurance Marketplace Standards Association (IMSA) for life insurers.

The Self-Critical Analysis Working Group has focused on: 1) the development of a set of principles related to self-critical analysis privilege legislation that states can reference when evaluating such bills; and 2) the development of a set of principles regarding accreditation programs and what role, if any, these programs should have in state market conduct programs. Key issues arising with the first goal include preserving regulator access to self-audits and striking an appropriate balance between giving companies credit for voluntary reporting of violations and maintaining regulatory flexibility with respect to enforcement. Key issues with respect to the second goal include assessing the quality of accreditation programs and determining what kind of recognition is appropriate for such programs.

b. Resource Guidelines

In 2000, the NAIC's Blueprint for the Modernization of Market Conduct Exams also addressed the fact that states vary significantly in the level of resources devoted to market conduct oversight. The Blueprint called for establishing resource standards in several areas including: 1) legal resources, allowing states to have the technology and other support needed to have the legal authority to address key market conduct issues; 2) personnel resources, allowing states to have appropriately trained examiners and other staff to conduct effective market conduct oversight; and 3) technical resources allowing states to have the technology and other support needed to conduct efficient oversight. The most important issue was to develop benchmarks that recognize that there are significant variations in state resources devoted to market conduct exams and the many other consumer protection functions states provide. As our Phase I study identified, some state departments do not have a separate and distinct market conduct unit.

In 2003 the Uniformity Working Group will continue to finalize the Market Conduct Examination Resources Recommendation document, which will define the market conduct function and the appropriate level of legal, technical and personnel resources each state should maintain to ensure effective market conduct exam activity, and develop an inventory of guidelines on other consumer protection functions.

c. Market Analysis

The market analysis initiative, launched in 2001 by the NAIC, grew out of the fact that financial oversight of insurers is divided into an examination function and an analysis function, which mutually reinforce and complement each other. The question is whether market conduct oversight could benefit from a similar approach. In his July 12, 2001 testimony before the National Conference of Insurance Legislators, Joel Ario unveiled a proposal for a market analysis program. Ario proposed that market analysis should be the most significant part of the NAIC's efforts to develop better tools to target insurers with market conduct problems and to identify developing market conduct issues that need to be analysed. He stated:

> "Given that no insurance department has the resources to conduct comprehensive examinations of all companies doing business in the state, market analysis could provide important tools for monitoring the broader marketplace so that problems could be identified and addressed at an early stage and so that exam resources could be targeted on the most serious problems.
>
> Market analysis tools could include everything from simple surveys on high priority issues, such as the surveys states currently are conducting on compliance with privacy laws, to market conduct annual statements analogous to the financial annual statement that is a bedrock of financial regulation. All states currently engage in at least some types of market analysis, if only to address pressing problems and choose companies for examination. So the real question is whether to add more structure to the process and place more reliance on such analysis to determine where market interventions are most needed."

The NAIC's Market Analysis Working Group has released a draft outline of a Market Analysis Program. A key NAIC goal in this area is to develop a "Market Analysis How to Guide" for states and a market conduct annual statement to identify priority issues. It appears that regulators believe that there may be existing data that can be used to gain a better perspective about their marketplaces and to learn whether a company may be operating outside of some predetermined norm of behavior. Regulators have asked for assistance from the industry in writing these "How to Guides" for the states in using such information as complaint data, changes in the annual statement Page 14 (i.e., "state page") information, and changes in company management.[11]

Regulators have launched a pilot Market Conduct Annual Statement Program encompassing the collection of both property and casualty and life data in nine pilot states. The data is then sorted to identify common "outliers" or those companies that appear to present the greatest risk of harm to consumers. The value of instituting a market conduct annual statement has been a matter of some controversy and there are differing opinions as to whether it should be a component of NAIC initiatives.

Participating states have agreed to use the market analysis to help focus market conduct resources on the 10-20 percent of companies that take the longest time to pay claims, have the highest ratio of claims closed without payment, have the highest ratio of cancellations to cars or homes insured, have the highest lapse ratio in life insurance and have the highest ratio of complaints to the number of policies or insureds. We would note that "significant changes" in these values are likely more telling than the values at a point in time.

The life version of the pilot ended on December 31, 2002, and there is some concern that the life industry annual statement pilot will have to be done a second time as problems have surfaced with the quality of life data received. Property and casualty data will be reported by September 1, 2003. Regulators have asked that industry monitor the costs of compliance with the Annual Statement, as it appears no cost-benefit analysis has been done by regulators. A question that has

[11] Page 14 of the property-liability Annual Statement, also called the "State Page", provides data on premiums, losses and expenses by line for each state. There is an analogous exhibit in the life-health Annual Statement containing the data elements that can be reported by state and line for life, annuities and health business.

gone unanswered is whether the states, particularly the nine pilot project states, have the resources to conduct, analyze and store the data a Market Conduct Annual Statement produces.

d. Interstate Collaboration

Also in 2001, an Interstate Collaboration initiative was launched by the NAIC and a working group formed to explore ways to reduce redundancy in market regulatory activities and to make efficient use of resources. The concept again borrows from financial regulation, where states focus on their domestic insurers and rely on the state of domicile to monitor the financial health of non-domestic insurers doing business in their jurisdictions.

The NAIC began its consideration of interstate cooperation with the concept of a zone examination approach proposed by Nebraska Insurance Director, Tim Wagner. In February 2002, Nebraska and Kansas executed a written cooperation or reciprocal agreement extending deference to market conduct examinations performed for insurers domiciled in the other state. Hence, to the extent Kansas performs a comprehensive market conduct examination of an insurer domiciled in Kansas or retains a contractor to provide such services, whichever the case may warrant, Nebraska will forego performing an examination of the Kansas domiciled insurer, and vice versa.

In March 2002, the "coordinated examination effort" was unveiled by the NAIC as a pilot program. Shortly thereafter, Commissioner and current NAIC President, Terry Vaughan of Iowa and Director Darla Lyon of South Dakota each agreed to participate in the program. The Ohio, Oregon, Illinois, and Nebraska Insurance Departments have recently joined in a second collaborative market conduct exam effort. This involved combining staff and resources to establish protocols to monitor state exams. The four states jointly identified and selected companies to be examined, and once this was accomplished, contributed examiners to complete the joint examination. This was essentially an Ohio-directed exam of a life company for all four states. Under this multi-state partnership, all four states will accept the exam report.

Director Wagner reported at the June 2002 NAIC meeting that Nebraska and two other states have recently participated in a new type of collaborative effort. They coordinated an exam of a broker-dealer with the Securities and Exchange Commission (SEC). Nebraska intends to coordinate in-house exams with the SEC when appropriate.

These efforts, aimed at reducing redundancy in the process of performing market conduct exams, are intended to serve as a resource for the NAIC in the committee work related to this topic. In 2003, collaborative regulatory initiatives will continue to be developed under the Market Analysis Working Group.

As Joel Ario stated at the July 12, 2001 NCOIL hearing, "If some form of interstate cooperation could be implemented, it would help address individual examiner qualifications, the standardization of the examination process, and the fact that some states do not actively engage in market conduct activities. Again, there appears to be more interest in this concept in the life industry than in either the health or property and casualty industries."

e. Market Information Systems Working Group

A new Market Information Systems Working Group has been appointed for 2003 to address how these systems may be modified to enhance state market analysis efforts and become more uniform with state data codes and collection techniques. Particular emphasis will be given to the Complaint Database System.

3. Industry Views on Current Market Conduct Reform Initiatives

The industry has closely monitored the NAIC's market conduct reform efforts and has commended NCOIL and the Foundation for their work in reviewing and analyzing market conduct examinations by state insurance regulators. The industry trade associations have offered congressional testimony supporting insurance regulatory modernization and have worked with their members to provide the NAIC with detailed recommendations for an effective and meaningful market conduct examination system.

The industry generally has been actively involved in the market conduct issue since the time of the McKinsey Study. An overview of the industry's current views on market conduct reform and their role in working with the NAIC is provided below.

a. American Council of Life Insurers

The ACLI is the largest trade association in the United States representing the life insurance industry. Its members consist of 399 legal reserve life companies. Of these companies, seven are domiciled in Canada. The members of the ACLI account for 76 percent of life insurance premiums, 75 percent of annuity consideration, 46 percent of disability premiums, and 65 percent of long-term care premiums in the U.S. ACLI member company assets account for 75 percent of legal reserve life company total assets.

While the ACLI continues to commit its full resources, along with those of its member companies, to support NAIC efforts to improve state regulation, it pursues regulatory efficiency and modernization along two tracks: 1) improvements in state regulation through establishment of uniform standards and administration in critical areas such as "Speed-to-Market", producer licensing and market conduct; and 2) a continued push of a legislative proposal to provide life insurers with the option of obtaining a federal charter.

Joseph Gasper, Chairman of the ACLI and President and Chief Operation Officer of Nationwide Financial Services, Inc., testified in June 2002 before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. Citing the failure of the current state-based insurance regulatory system to keep pace with changes in financial services, Mr. Gasper urged the congressional panel to provide insurers a federal chartering option. He stressed that the life insurance industry and its customers need a prompt and comprehensive approach to regulatory problems that only Congress can provide. "Many life insurers believe regulatory modernization is a survival issue," Gasper testified. "In that context, the speed with which progressive change takes place is critical. Today's marketplace is intolerant of inefficient competition." Gasper testified, "Life insurers, along with the banking and securities industries, are the triumvirate of essential financial service providers. And yet, despite the striking parallels between the three in terms of their products and their importance to the financial health of the nation, there is no federal mechanism to address insurance issues on a broad scale."

The ACLI's Market Conduct Examination Reform Proposal, presented to the (D) committee in June 2001, represented the detailed views of company members, both at the operational and executive levels, on the uniformity of exam procedures and the establishment of a zone system for conducting market conduct examinations. The ACLI's current view at the time included the following:

- A consistent program for examiner's training, with outside contractors trained at the same level as employees.
- Exam costs should not be affected by the use of an outside examiner, i.e. standard examiner compensation.
- Regular three year scheduling of exams, with targeted exams only for a specific pattern of activity and with reasonable justification.
- Substantive review should be left for "trends" that require additional scrutiny. Recognition should be given for having systems, written procedures, and periodic checks in place.
- Use of offsite audits should be utilized to the greatest extent possible.
- The need for examiners to follow the NAIC Market Conduct Exam Handbook.
- Recognition of IMSA members' efforts to maintain compliance.
- Development of strict procedures for handling documents and confidential information.
- Standardized guidelines for any administrative actions or practices.
- Actions should be based on general practices not random errors.
- Consideration should be given for compliance actions, i.e. fines imposed only if insurer does not take action by a specified date.
- Company responses to any disputed issues should be in the text of the report.
- Development of an annual market conduct reporting process, using a consistent format for basic information which states could review and use to reduce reliance on an exam.

This should be suitable for multi-state insurers. Include all standard information used for market conduct exams.

- Support for the NCOIL Model Act on "Insurance Compliance Self-Evaluative Privilege" with strict protocols for the handling of confidential and privileged information.

It is important to note here that an indirectly related, state-based initiative to implement a nationwide uniform filing and approval process for life and annuity products was launched in March 2002 by the NAIC. The key component of this initiative is the formation of an interstate compact. The advantages and practicality of a compact to address troublesome product approval issues are obvious. With uniform standards, consistent interpretation of those standards, and a single point of contact for dealing with multiple jurisdictions, insurers will be able to achieve speed to market advantages. The interstate compact device could become a potent tool for state regulation at a time when the states are under the gun to achieve efficiency and uniformity in several important areas of state insurance regulation. The NAIC adopted the Interstate Insurance Product Regulation Compact (IIPRC) at their December 2002 meeting in San Diego, California.

b. The Property-Casualty Trade Associations

The National Association of Independent Insurers (NAII), the National Association of Mutual Insurance Companies (NAMIC), The Alliance of American Insurers (AAI), and the American Insurance Association (AIA) commend the NAIC for examining ways to improve market conduct examination procedures. The trade associations have discussed suggestions and recommendations for improving these procedures with their members, and members of all four trade associations endorse this important work.

In June 2001, all four property-casualty trade associations presented to the NAIC a uniform twelve-point program for improving market conduct exam processes. The specific proposals at that time are listed below. It is important to note that their recommendations include measures which state insurance departments may undertake under current statutory authority and therefore could be implemented immediately. The specific measures advocated at that time can be summarized as follows:

- Market conduct exams should concentrate on identifying general business practice standards rather than focus on single inadvertent errors in order to best protect consumer interests while maximizing the use of market conduct resources.
- There should be greater use of the Examination Tracking System.
- Departments should rely on targeted market conduct examinations rather than comprehensive examinations.
- The NAIC should develop and the Departments should follow uniform standards on examination notices, including sufficient advance notice and notice regarding a change in scope of the examination.
- Departments need to exercise greater oversight and control of examination costs. Specific methods for doing so were presented in the twelve-point program.
- All states must adopt and adhere to the procedures and guidelines set forth in the NAIC Market Conduct Examiners Handbook.
- The NAIC should develop and the Departments should follow uniform standards for requesting data from insurance companies during market conduct examinations.
- As concerns final examination reports, the NAIC should develop and states should follow a uniform standard for when such final examination reports must be completed and insurance companies should be given the opportunity to include within the final examination report a discussion of any disagreements that the company has with the findings and the company's reasons for those disagreements.
- There must be a rational basis for assessing administrative penalties and establishing the size of those penalties.
- The NAIC and states should continue to adopt minimum training standards for market conduct examiners.
- Insurance companies must be given sufficient time in which to come into compliance with new or amended statues and regulations that require changes in company operation. The NAIC should encourage and state insurance departments should work with the industry in promoting this objective in all legislation and regulation impacting company operations.
- The NAIC should adopt NCOIL's Insurance Compliance Self-Evaluative Privilege Model Act as an NAIC model.

More recently, the property-casualty industry trades submitted a draft outline for a "Guide to Market Conduct Analysis" to the NAIC. The draft will assist state insurance regulators in making better use of existing data, thereby reducing the need for costly and time-consuming extra data calls.

The industry's "Guide to Market Conduct Analysis" promotes a consistent approach among the states for market conduct analysis based on information that states already have and develops some broad indicators to identify insurers with potential market conduct/compliance problems. Mr. David Reddick, NAMIC Market Regulation Manager, has stated "We believe that the regulators should use existing data to determine if companies are acting responsibly in the marketplace before asking for new information. There are strong indications that this current data is not even being used today."

In a May 29, 2002 letter to the NAIC's Market Conduct Analysis Working Group, the property-casualty trade groups pointed out three types of information states already receive that could be used to give a general indication of companies that may merit further review. They are: complaint data, certain IRIS ratios and changes to page fourteen of the statutory statement. The guide gives an overview of how this information can be maximized for market conduct analysis. The trades also pointed out that the guide "presents an analysis that all states can accomplish with their current resources, regardless of whether or not they have a market conduct examination unit. It promotes a consistent approach to analysis among the states, the net result of which could be a more rational and effective system of market conduct review and examination. The information to be used under this guide is readily available to all states and covers all companies and all lines. Most important, the joint trade group believes that if all states would do this type of market conduct analysis, redundancies could be eliminated, focusing state resources on companies with problems."

The NAII has cautioned the NAIC Market Analysis Working Group that their efforts to test the market conduct annual statement proposal through a pilot program involving 9 states could mean significant additional expenses for insurers. The NAII seems to believe that the NAIC's efforts to test the market conduct annual statement concept may create substantial expenses because of the volume of additional data requested for this annual statement within such a large pilot program. In addition, NAII has concerns that not all of the states in the pilot program will have the resources necessary to do the type of analysis needed of the information provided by insurers.[12] The NAIC's goal to complete this expansive program with a comprehensive report by years' end (2003) could clearly be too short a timeframe to allow for adequate data collection and analysis, according to the NAII.

Another critical concern is the confidentiality of the information collected from companies. It is essential that all of the states participating in the pilot project have adequate confidentiality laws to protect proprietary information collected from insurers as part of the pilot, according to the NAII. This has become a particularly resonant issue in recent years with legal battles over the release of insurer-specific market data and the use of such data by plaintiffs' attorneys to initiate lawsuits against insurers. Legislators and regulators can mitigate these concerns by promulgating strong and explicit legal prohibitions against public release of insurer-specific data. If regulators do their job in using these data, a good argument can be made against the need for or value of public release of insurer-specific data.

The NAII noted that this same NAIC working group is developing another project on how regulators can best use the data they already receive to analyze what is happening in their markets. The regulators were encouraged to utilize fully existing information currently available before embarking on a new and probably costly data collection effort. We should point out that the NAIC has developed an array of analysis tools and computer applications that enable regulators to better use the financial data that are reported.

[12] There is a long history of data calls and reports that have been under-utilized by regulators. Some data reporting requirements that were imposed in response to the "liability insurance crisis" of the 1970s offer good examples of this. On the other hand, some regulator-imposed data reports, such as the Fast Track Monitoring System, have become widely utilized by regulators and insurers. The lesson is to carefully consider new data reports to assess whether they will be sufficiently valuable and are likely to be really used by regulators.

4. Views of Consumer Advocacy Groups

Funded consumer representatives bring a unique and vital perspective to the work of state insurance regulation, something which is critical as regulators carry out their mission to protect consumers.

This study includes only general comments which have been made by consumer groups with regard to the NAIC's current market conduct initiatives. Consumer groups consistently have argued that state insurance regulators need to raise the bar on market conduct examinations in all states.

Birny Birnbaum, economist with the Center for Economic Justice, has stated that an effective market analysis program is the only way the states can identify problems efficiently and target their resources. A shift of resources to the market analysis function is absolutely essential, according to Mr. Birnbaum. In particular, Mr. Birnbaum and others have argued that regulators should be collecting and reviewing underwriting guidelines to see what insurers are doing in the marketplace, as well as Zip code data by line, yet half the states do not collect these data. According to Mr. Birnbaum and others, analysis of complaint data and "state page data" alone do not reveal how companies are treating various groups of individuals in various geographical areas, or whether insurers may be moving blocks of business to higher rate schedules.

Mr. Birnbaum believes that the primary motive for regulators to collect data should be to monitor insurance markets to assure that they are working to the benefit of consumers. Mr. Birnbaum indicates that he does not believe that insurance markets are always competitive and that competition alone will work to benefit consumers in the insurance industry, the way it may work in other industries. An insurer's ability to underwrite risks subjectively and to use combined insurer data to develop rates and products warrants government and consumer group scrutiny of insurer practices, according to Mr. Birnbaum. The Center for Economic Justice has consistently advocated monitoring markets in more specific geographic areas and lines of business.

Deborah Goldberg, Co-Director, Neighborhood Revitalization Project has suggested that market conduct resources be allocated to conduct testing to see what is actually occurring in the marketplace. She has suggested that there are some insurer practices that never make it into a paper trail for market conduct examiners. Ms. Goldberg has argued for example that there are some indications that African American home buyers are subject to discriminatory practices. "Some individuals do not receive a return call from an agent, and therefore do not receive a quote." She has suggested that adequate resources be made available to enable departments to hire outside testing agencies to determine what types of activities may be occurring. Ms. Goldberg has stated that this testing should be completed as part of a market conduct examination, by individuals who have the expertise to conduct this type of testing. Ms. Goldberg further believes that a healthy dose of "skepticism" is needed regarding regulator's use of insurers' self-analysis data.

The proposed use of reciprocity agreements to facilitate interstate collaboration on market conduct exams has raised several issues among consumer groups. Signatory states to a reciprocity agreement would agree not to conduct market conduct exams of the domestic insurers of other signatory states, provided that the state of domicile has baseline information on its domestic insurers and has acted on it. Once a state signs the reciprocity agreement, they can conduct only targeted exams of the domestic insurers of the other signatory states, limited to their state specific issues, with prior notice to the domestic commissioner.

Consumers have urged regulators not to move to this system of domestic deference, as insurers generally have substantial economic and political and influence in their domestic states. Consumers have stated that regulators should first insist that the staff of the insurance department and its resources should be commensurate with its domestic industry. Standards should then be established for the qualification of insurance department personnel doing the reviews.

5. Views of Congress and the U.S. General Accounting Office

While acknowledging some successes, key federal legislators continue to express concern with the lack of uniformity and inefficiencies in state insurance regulation. Unless states reach a consensus on what state-based reforms should be, key federal legislators will begin to move toward supplementing the current patchwork of state insurance regulation with federal chartering options or other federal standards. We understand that the U.S. General Accounting Office is studying the Market Conduct Surveillance System as it currently exists. It is expected that this study will be completed and released soon.

D. ECONOMIC THEORY AND INSURANCE MARKET REGULATION

1. Theory of Regulation

The economic foundation for regulation is based on the concept of market failure. In some instances, regulation can correct or compensate for market failures and improve market performance and the welfare of consumers. Market failures constitute violations of the requirements for workable competition, such as entry and exit barriers, excessive market concentration, and lack of information.[13] We make a distinction between market failures and market "problems." Conditions that are perceived as market problems, such as high prices, or diminished availability of coverage, can be a consequence of a market failure or other factors in a competitive market. In other words, not all market problems are necessarily caused by a market failure. For example, high insurance prices may be the natural result of a high risk of loss driven by external factors and not the malfunctioning of the market per se. It is important to determine the underlying cause(s) of market problems to determine whether a regulatory remedy is warranted (i.e., necessary and feasible).

Regulation is primarily suited to remedy certain market failures and not necessarily market problems that are caused by other external forces. The basic premise underlying the need for regulation is that market failures can diminish the efficiency and equity of market outcomes and harm the public interest. The purpose of regulation is to correct market failures, or at least minimize their negative effects, and improve market efficiency.

However, not all market failures can necessarily be remedied by regulation in such a way that the benefits of regulation exceed the costs that it imposes. Also, some regulatory remedies may be

[13] See Klein (1999) for a more detailed discussion of regulatory principles and their application to insurance.

more efficient than others. Hence, it is reasonable to assert three conditions necessary for regulation to serve the public interest (Skipper and Klein, 1999).

1. There must be a market failure that causes significant harm to consumers and/or the public interest.
2. It must be feasible to remedy or counteract the effects of the market failure through regulation.
3. The most efficient regulatory measure(s) should be employed; i.e., regulation should maximize social welfare or benefits over costs.

The system for regulating insurance market practices should be founded on these basic principles.

The principal insurance market failures that may warrant regulation of firm conduct are imperfect information and principal-agent conflicts. Some consumers may be hampered in their knowledge and understanding of insurance transactions and ability to fully protect themselves from abusive practices. Abusive practices are broadly defined as actions that take "unfair" advantage of a consumer with material harm to the consumer. If consumers were fully knowledgeable about their insurance needs and options, presumably they could avoid transactions that were not in their best interest. For example, consumers with full knowledge could not be misled with respect to the expected returns on universal life insurance policies. The reality is that it is difficult for many consumers to assess policy provisions and their financial implications, particularly for complex insurance products (Joskow, 1973; Schlesinger, 1998). Consequently, an insurer or an agent could lead some consumers into buying insurance policies under terms that are detrimental to the consumers.

Principal-agent conflicts potentially arise after a consumer has purchased an insurance policy and paid premiums to the insurer (the policyholder is the "principal" and the insurer is the "agent"). The policyholder's interest is to have claims paid fully and promptly but a given insurer may seek to increase income for owners by retaining funds that should used to pay claims. In theory, competition and reputational considerations should reconcile policyholder and insurer incentives.

However, certain insurers may ply a different strategy and take advantage of impediments to and lags in the dissemination of information about their practices.

Some also might argue that unequal bargaining power between insurers and consumers can result in market abuses. The argument is based on the premise that an insurance company has greater economic resources than a typical personal insurance buyer and a small commercial insurance buyer. This should not have an adverse effect on insurance transactions ex ante if there are a sufficient number of insurers competing for business. However, after an insurance policy is purchased, problems could arise. For example, an insurer could refuse to pay a claim that should be paid according to the terms of the policy. The policyholder could sue the insurer, but litigation can be costly and involve considerable delay. The policyholder may not have the financial resources to sustain a lawsuit. Hence, it could be argued that regulators should weigh in on the side of policyholders in such instances to ensure that insurers fulfil their contractual obligations to policyholders.

The types of regulatory mechanisms that could address these market failures are broadly characterized here. First, regulators may impose certain limitations on or requirements for insurance transactions and contracts ex ante. Regulators cannot ensure that every insurance transaction is optimal for consumers, but they may discourage or prevent a large number of certain kinds of transactions that would result in significant and pervasive harm and company practices that promote such transactions.

A second mechanism is the setting and enforcement of certain standards with respect to insurers' activities. Currently, the states regulate several insurer functions in this manner, including:

- marketing and sales;
- underwriting;
- financial exchanges (e.g., dividends, refunds, etc.);
- policy terminations; and
- claims handling.

Arguably, the regulation of marketing and sales practices is necessitated by imperfect consumer information – the regulatory objective is to prevent or penalize deceptive practices. The economic rationale for regulation of underwriting is less clear. The regulation of financial exchanges, policy terminations and claims handling could address potential problems created by all three identified market failures - imperfect information, principal-agent conflicts and unequal bargaining power.

A third regulatory activity affecting market conduct is the provision of consumer information and education. Insurance departments have increasingly used this method to enable consumers to better discern deceptive practices and avoid unfair transactions, and also make them aware of their legal rights and the remedies available in the event of disputes with insurers. This latter objective also serves to enhance the utility of complaints as a source of information to detect and target market conduct problems. While some may question the extent to which we can expect consumers to become informed, it would be a mistake not to take full advantage of consumer education and information to the extent that it can serve consumer protection objectives.

2. Capabilities of Regulators

Effective regulatory intervention requires that regulators have good information and can determine and implement the correct market solution. However, regulators face certain practical constraints in remedying market failures. Perhaps the most important constraint is limited information. In industries where there are millions of transactions, such as insurance, it is not feasible for regulators to review and ensure the "correctness" of every transaction. Further, complex transactions involving numerous, specific considerations of the participants present greater challenges to external review and correction. Hence, it is often difficult for regulators to divine and impose optimal terms for market transactions.

Some states have sought to review a large number of transactions ex post through market conduct examinations. Rather than evaluating each transaction on its own merits, the tendency is to judge certain insurer actions against arbitrary standards. For example, a state may require the steps involved with paying a claim to occur within specified time frames. However, there may be good reasons for why the steps taken with respect to certain claims do not occur within a specified time frame. The implications of information constraints for what should be regulated and how it should be regulated warrants further discussion.

Regulators and firms also have limited resources. Of course, the government can exact greater taxes and fees to fund additional regulatory activity, but these costs are ultimately passed to taxpayers and consumers. This is also true for firms' costs of regulatory compliance. Legislators and regulators must explicitly or implicitly perform a cost-benefit analysis in choosing an optimal level of regulatory activity and how limited resources will be employed.

3. Factors Affecting Regulatory Policy

The theory of regulation articulated above is normative in the sense that it prescribes what regulators *should* do. The world is not so pure, however, and a number of factors influence regulatory policy and cause it to depart from what would be in the best long-run interests of consumers and the general public. These factors include the relative political influence of firms, consumers and other interest groups, ideologies (i.e., philosophies of regulation), the saliency and complexity of regulatory issues, bureaucracy, and regulatory resources (see Meier, 1985). With respect to regulatory policy, what voters might perceive to be in their best interest (e.g., mandated service requirements or "take-all-comers" laws) and what is truly in their best interest are not always the same things. Legislators and regulators must maneuver through a hazardous political minefield in setting policy. This is relevant to choosing a regulatory framework because opening an area of market activity to regulatory oversight, such as pricing, invites the intrusion of forces that may harm the public interest.

Certain lines of insurance receive significant public attention. Consequently, public perceptions and political considerations can weigh heavily on insurance regulatory policy involving these lines (see Meier, 1988). Most insurer-consumer interactions are obscured but they sometimes generate considerable public concern, such as underwriting actions in home insurance. Regulators tread a fine line between promoting market forces and maintaining sufficient political support to retain their office. This is a practical consideration in designing a system for market conduct regulation.

III. RECOMMENDATIONS AND DISCUSSION ON THE PURPOSE OF MARKET CONDUCT SURVEILLANCE

A. PURPOSE AND SCOPE OF MARKET SURVEILLANCE

1. Philosophy and Approach Towards Market Conduct Regulation

Fundamentally, there needs to be a rethinking of the philosophy and approach towards market conduct regulation and surveillance. The current system is too focused on the "trees" versus the "forest." Regulators have fallen into a bureaucratic overemphasis on detecting, correcting and penalizing numerous, minute processing errors. Regulators have become de facto quality control auditors for insurers. This is not an efficient use of regulatory resources and it does not serve the public interest.

We believe that the purpose of market conduct regulation is to prevent and remedy unfair trade practices that have a substantial adverse impact on consumers, policyholders and claimants. The purpose of market conduct regulation is not to find and correct minor insurer errors, nor should it waste resources on detecting and sanctioning minor violations of laws and regulations. Regulators should pursue significant abuses and take actions that will result in the mitigation of the greatest harm and restoration of the greatest benefit to consumers and the public.

We recommend that legislators and regulators, with other stakeholders, focus on the overall performance of insurance markets and prioritize areas of attention with appropriate, targeted strategies and remedies. This will require agreement on stated goals and objectives for market performance and how achievement of these targets will be assessed. Certain identified problems will stem from structural flaws in the market that will manifest themselves in improper market practices. What is important, however, is improving market outcomes, not racking up a large number of violations and fines. Some of the identified problems may be amenable to conventional regulatory measures while others may warrant different public and private remedies. In a given instance, a structural fix (curing the cause) rather than policing of firm actions (treating the symptoms) may be most effective.

This view of market conduct regulation is not entirely original. Indeed, it is reflected to some extent in the recommendations of the McKinsey report. The McKinsey report espoused a philosophy that market conduct surveillance should be focused on companies that are engaging in unfair business practices, rather than those insurers that infrequently and unintentionally treat policyholders unfairly. In other words, regulators should focus on a pattern of unfair practices or actions, rather than inadvertent and occasional mistakes.

We recommend taking this approach a step further by focusing on market outcomes in regulating market conduct and prioritizing surveillance activities rather than adhering to a process-based view. This would naturally focus attention on insurers and practices that have the greatest impact on the market. Below we suggest goals and objectives that might be considered for a system oriented towards market outcomes.

Furthermore, careful thought should be given to the types of company actions that fall within the scope of traditional market conduct surveillance/enforcement measures and those practices that do not. We recommend that traditional surveillance/enforcement measures be confined to clear violations of laws, regulations and insurance contract provisions and other blatantly improper practices that have a significant, negative effect on consumers. For example, the deliberate underpayment and/or delay of claims payments would be within this scope. On the other hand, the review of underwriting decisions according to regulators' sense of what is reasonable would not be within this scope. Also, substantial regulatory resources should not be wasted on minor and occasional errors and law violations (e.g., a policy termination notice that marginally misses a state mandated deadline).

This does not mean that regulators should ignore market practices that were not legal violations or blatantly improper, yet raised legitimate concerns about fairness and negative effects on consumers and market outcomes. However, such practices would be subject to a different kind of process. Regulators would evaluate the practices in consultation with insurers and other stakeholders and determine if any action is warranted and what it should be. A given problem could compel a change in law or regulation, embodied in published market conduct standards and become subject to traditional enforcement measures. However, it more often may be addressed through other regulatory tools and cooperative efforts with insurers.

2. Regulatory Goals and Objectives

Many people speak about the "availability and affordability" of insurance. These terms are acceptable for certain purposes but they do not lend themselves to measurement. We suggest the following general performance goals that are rooted in economic theory and can be translated into indicators subject to objective assessment.

1. Efficient prices;
2. Reasonable access to insurance by insurable and serviceable risks; and
3. A quality of service commensurate with what buyers are willing to pay for.

We can explain what each of these concepts mean. Efficient prices are the prices that would be set in a perfectly competitive market and would be just sufficient to cover the costs (including the cost of capital) of an efficiently run insurer. Efficient prices would also vary with the risk of the insured to the extent that it is economically feasible to measure and price risk differences.

Generally, price levels are not something evaluated by market conduct regulators. Price levels are determined by competition except when regulators suppress rates below a competitive level. Market conduct regulators focus on whether an insured is charged the "correct" price based on the insurer's filed rate plan. Still, abusive market practices could result in excessive prices even if they are consistent with insurers' rating plans and, hence, could be subject to market conduct enforcement actions or other remedies.

Access means that an individual or firm with an insurable risk can purchase adequate insurance coverage at an efficient, risk-based price. Access does not ensure that a buyer has sufficient financial resources to purchase the coverage he needs or desires, i.e., that he can "afford" to buy adequate insurance. It also does not mean that the buyer can purchase coverage from any insurer he prefers. As long as a sufficient number of insurers serve a given market with efficient prices and are willing to underwrite insurable exposures, access exists. This definition focuses attention on the supply of insurance for a given market, rather than the actions of a specific insurer.

The insurer functions that most affect access are product design, marketing/distribution, and underwriting. However, access is denied only when all (or most) insurers engage in improper practices so that sufficient sources of coverage do not exist. This suggests that regulators should examine certain practices of multiple insurers to determine if there are patterns of unfair behavior that severely impede access to insurance and hurt consumers. The regulatory response might be conventional enforcement measures, alternative remedies, or some combination of both.

Quality of service is the market outcome that is most clearly linked to areas of traditional market conduct surveillance and enforcement. Broadly construed, it could encompass all of the aspects of market performance not encompassed by efficient pricing and access to coverage. At the same time, quality of service is the most subjective aspect of market performance and the most difficult to assess or quantify. Clear and quantifiable quality measures cannot be readily extracted from outside the regulatory system. Indeed, the standards adopted by market conduct regulators effectively become the measures of quality of service. To ensure the credibility of the system, the standards established should emanate from a deliberative and transparent policymaking process and not arbitrarily from the whims of individual regulators. Also, economy should be exercised in selecting a limited number of critical standards rather than promulgating numerous standards in an attempt to micro-manage (or micro-regulate) insurers' service related activities.

There are other market conditions that are related to the above goals that may be of interest to the public but cannot be addressed solely by competition or regulation. This is relevant because market conduct regulation is sometimes used inappropriately to address these conditions. The best example of this is a situation where costs are escalating rapidly because of external factors, such as tort law trends for liability insurance. In such a situation, insurance prices must also rise commensurate with costs, which may strain the budgets of insurance buyers. In some cases, the supply of insurance may effectively dry up because the exposure to risk becomes uninsurable. These are not conditions that can be fixed by regulation, but regulators may play a role in working with legislators and other stakeholders in developing economically sound remedies that address the underlying problems.

3. Elements of An Effective System

The McKinsey report identified three elements for an effective and efficient system for market conduct surveillance. It is helpful to review and reconsider these elements in light of how insurance markets have evolved and 30 years of experience in market conduct regulation. The elements recommended by McKinsey were:

- A complaint analysis system that targets problem companies and lines;
- A system for scheduling targeted field examinations; and
- Field examination procedures tailored to the scope and depth of a company's operations and problems at issue.

We should note that McKinsey did not recommend routine, comprehensive market conduct examinations of insurers. This contrasts with actual practice, as many states perform both routine (e.g., once every three years) and targeted market conduct examinations that focus on particular areas and are triggered by some occurrence or information.

These elements seem reasonable for the time and context in which they were conceived, but we believe they can be improved for current times. We propose the following elements for an effective and efficient framework for market conduct surveillance.

- A system for identifying, assessing and prioritizing market conduct problems;
- A mechanism for developing and implementing appropriate strategies and means to remedy significant market conduct problems;

- A program for complete communication and coordination among states to make the most effective use of regulatory resources; and
- A procedure for assessment of regulatory performance and effectiveness in addressing significant market conduct problems, as well as market outcomes.

In the early 1970s, it was obvious that consumer complaints were the best indicators of market conduct problems with follow-up by examinations and this method will continue to be important. However, other information sources and technologies have evolved and it would be appropriate for regulators to develop a comprehensive and integrated system for detection and follow-up that makes the most effective use of the information sources available. Potential market conduct problems would be mapped to the most efficient and effective detection and assessment mechanisms. The goal would be to create a net that would be expected to catch most if not all significant problems but also avoid unnecessary duplication and waste of resources. Further, detected or suspected problems would be prioritized for regulatory attention.

Ideally, all states would work together in operating such a system and use it to assign tasks to the participating regulators. A natural extension would be a process in which the states would determine how identified problems would be addressed. This would involve research on and development of effective remedies for different types of problems as well as decisions on how a specific problem or conduct violation would be addressed and who would be responsible for implementing the remedy. Assessing a given problem could be assigned to small group of states but the remedy could require action by all affected states.

The first two elements presume the third – complete communication and coordination among states. This would naturally encompass the Examination Tracking System but would preferably extend beyond ETS. Moreover, states would be compelled to fully participate, not just invited to do so. Recent NAIC and state initiatives appear to substantially increase opportunities and incentives for the states to voluntarily coordinate their efforts. Should this be institutionalized in the form of a national market conduct oversight body, akin to the NAIC's Financial Analysis Working Group that monitors and coordinates state action with respect to the financial condition of "nationally significant" insurers? A formal, national oversight entity could immediately resolve communication and coordination issues, efficiently monitor market conduct, and effectively guide the states on necessary remedies and enforcement actions. However, as with other multi-state entities, such a proposal would raise state sovereignty and autonomy questions in an area where the states have traditionally retained a high level of independence.

The final element – an evaluation mechanism – would help to ensure two things. First, it would institutionalize a process by which the states' progress on substantive and procedural reforms would be assessed. Second, it would provide a feedback mechanism in the market conduct system to judge the efficacy of detection tools and regulatory and industry remedies. Regulators would not simply assume that a particular tool or remedy works or that a problem has been fixed, but would follow-up and determine whether further action is necessary or a change in methods is required.

4. Areas of Regulatory Concentration

Government officials, with public input, will need to determine the areas where conduct surveillance and enforcement efforts should be concentrated to promote market goals, based on sound economic principles. Specific and detailed recommendations on these areas are beyond the scope of this report but we can discuss certain areas in more general terms to illustrate our point.

To begin, for personal and auto home insurance, the areas of policy renewals, terminations, refunds, and claims payment and settlement would seem to be the areas where regulatory surveillance would be most needed. Renewals and terminations can be significant because of mandatory requirements for these coverages and the potential for some insurers to attempt to abruptly alter their portfolios of exposures or engage in ex-post underwriting. Disputes over auto and home claims are more likely to arise as payments are based on indemnity and an assessment of the insured's losses rather than a pre-stated amount found in valued policies, like life insurance. The fact that auto and home policies are relatively standardized suggests that marketing and sales warrant less concentration. This does not mean that regulators would ignore market conduct violations in these areas, but would expend fewer resources in attempting to pro-actively root out violations.

The underwriting of auto and home insurance requires some further discussion. Most states have statutory provisions that prohibit underwriting based on certain socially unacceptable factors such as race. Some states expand prohibited factors to include sex and the location of a home (as a sole determining factor). Beyond this, some regulators may review underwriting decisions in market conduct exams for "reasonableness" and consistency with company underwriting guidelines. We question the need for extensive and intensive regulatory review of underwriting, recognizing that differing views and politics are involved. The generally wide access to auto and home insurance, even with the recent market tightening, implies that insurable risks can find a source of coverage, albeit not always their first choice. In other words, if a sufficient number of insurers adequately serve a given geographic market, is it cost-effective for regulators to review the underwriting practices of all insurers?

In contrast, for life insurance and annuity products, marketing and sales are the most prominent regulatory areas, while benefit payments would seem to be less prone to conduct problems. Further, life and annuity products involving variable components are most subject to misrepresentation. There is probably little disagreement on the need for effective regulatory surveillance of the distribution of these products. The disagreements arise over how regulators should police this area.

The delivery of provider services and claims payments are the primary areas for regulatory attention in health insurance. This would include other aspect of managed care systems, such as pre-authorization of services. Regulators are climbing a learning curve on how to monitor and assess quality in managed care systems. This is a particularly complex and challenging area that requires special study. Marketing and distribution of individual health policies also may warrant some monitoring if product misrepresentation becomes a problem. Further, certain products such as long-term care insurance could be subject to an array of conduct issues because of their complexity and potential cost pressures when policyholders begin to draw benefits.

Certain personal insurance coverages such as title insurance and the various forms of credit insurance pose special issues. Consumer advocates and certain regulators have expressed significant concerns about how these products are sold. This suggests that regulators may need to concentrate their monitoring on the marketing and sales of these products. At the same time, in terms of dollars, these lines are relatively small and it would not seem cost-effective to devote large amounts of regulatory resources to them.

For commercial property-liability insurance, the priority areas for regulatory surveillance vary with the type of coverage and size of buyer. Generally, resources should be focused on transactions involving small buyers. Some products purchased by small buyers, such as Business Owners Policies, are relatively standardized. Hence, marketing and sales would seem to warrant less regulatory surveillance than claims. Other products purchased by certain small buyers may be more specialized and what regulators can contribute here is unclear. Workers' compensation is a special case and state workers' compensation commissions are involved in the oversight of insurers' administration of these policies.

B. PART II PREVIEW AND REGULATORY STRATEGIES AND MECHANISMS

In Part II below, we present the essential elements of a revamped market conduct regulatory system. This includes, but is not limited to: 1) key provisions in a revised model market conduct law; 2) interstate coordination; 3) exam procedures; and 4) exam types – targeted versus routine exams. Also, we will address regulatory approaches and tools that are under development or have been proposed, such as the market conduct annual statement. In addition, there are several aspects of market conduct regulation that deserve some mention here, as they are important to our Part II recommendations.

1. Market Conduct Standards

The standards by which firm conduct is judged and sanctioned are fundamental to the regulatory system. Currently, these standards exist in law, regulation, other documents and the minds of regulators. To the extent that standards can be made explicit without becoming overly arbitrary, both insurers and regulators should have a clearer understanding of what is expected and what will be subject to enforcement actions. Articulated standards also provide a basis for discussion by all interested stakeholders on what conduct will be considered improper. The potential downside to some articulated standards is that they may "codify" restrictions that some might consider to be excessive or limit regulators' discretion when discretion is in the best interest of consumers. Still, we would prefer to err on the side of transparency and clear expectations.

2. Passive Versus Active Detection Methods

Passive detection mechanisms rely on problems and conduct violations to reveal themselves before regulatory action is initiated. The use of consumer complaints to direct market conduct regulatory activities is a good example of a passive detection mechanism. Passive detection may be the most efficient method for certain types of problems and violations where active detection is not feasible or would be very costly relative to the number and severity of the violations that would be found.

Other types of problems and violations may be best detected through active methods where regulators determine if insurers are in compliance. The best current example of an active method is a comprehensive, on-site periodic examination in which regulators audit insurer records. "Bench audits", testing and insurer reporting represent other active methods. The advantages of active detection are more timely regulatory action and greater assurance of regulatory compliance. The disadvantages are greater cost and the potential misallocation of scarce resources.

Neither passive or active detection methods are uniformly superior – the best strategy is likely to be an effective combination of both that optimises their use and the deployment of regulatory resources. The key here is that regulators approach the selection and employment of passive and active methods deliberately to maximize their objectives.

3. Regulatory and Firm Roles

In the traditional approach to market conduct regulation, the firm's role is to comply with regulations and cooperate with regulators and the regulators' role is to verify firms' compliance and sanction violations. In the new approach, firms undertake a greater responsibility to verify their compliance and regulators verify that firms perform this responsibility and address any unresolved violations or problems. We call this a new approach although it is employed in other industries and there are illustrations of it even in insurance. One such illustration is the Statistical Data Monitoring System, adopted in 1980s, to ensure accurate statistical reporting by property-casualty insurers and statistical agents.

We discussed insurer self-compliance activities at some length earlier in this report so it is not necessary to repeat that discussion. The point we wish to make here is that the regulated entity has an important, active role to play in market conduct regulation. The enormous number of insurance transactions and insurers' self-interest in good market practices establish both a need and the opportunity for a strong self-compliance role. The task is to coordinate insurers' and regulators' roles and responsibilities in a way that will make the most efficient use of resources, promote proper incentives, and ensure regulatory objectives are achieved. A key aspect is how regulators will be assured that they can rely on an insurer's self-compliance system.

4. Enforcement Actions and Firm Incentives

An important strategy of any regulatory system is to promote firms' incentives to be in compliance. This supports the objective of having firms employ good market practices and minimizing abuses and violations that require regulatory action. Regulatory monitoring and enforcement sanctions will strongly influence firm incentives and behavior. If violations are likely to go undetected (and unsanctioned) then firms that would otherwise be inclined to engage in abusive practices will have no external incentive to avoid such practices. If sanctions and penalties are weak and the potential economic gains from abusive practices are great, then some firms will be more willing to risk engaging in these practices. Regulators must assure that firms' cost-benefit calculations favor good market practices and regulatory compliance.

In our Phase I survey, a number of insurers expressed concerns that enforcement actions and penalties were inconsistent and that minor, inadvertent infractions were excessively penalized. These concerns should be addressed with consistent and rational policies that apply sanctions commensurate with the nature and severity of violations. Further, regulatory policies should not discourage insurers from finding and rectifying their violations.

5. Improving Consumer Information

There is a close relationship between consumer information and market conduct problems. As we discussed in Section II, lack of consumer information and knowledge create opportunities for some insurers and agents to take unfair advantage of consumers. It follows that better informed and knowledgeable consumers will be less prone to certain kinds of unfair practices, such as misrepresentation of insurance policies. The quantity and quality of information available has increased over time. Whether the average consumer has become more knowledgeable is an open question, especially in relation to the greater complexity of some insurance products.

Still, improving consumer knowledge should and has become an important activity for insurance departments. It is a natural complement to the monitoring and enforcement aspects of market regulation. Information programs can be used as a component of an integrated strategy to help remedy or mitigate certain market abuses. This is not to suggest that information can be expected to obviate the need for more traditional regulatory measures but it may help to diminish the scale of some problems and enable a more efficient use of regulatory resources. Information technology has made it relatively easy and inexpensive to provide information to consumers. The challenge lies in getting consumers to access readily available information and become knowledgeable. There is also an issue of responsibility – to what extent should consumers be expected to assume some responsibility in avoiding improper transactions versus relying on regulators to protect them from unfair practices?

6. Constraints on Regulatory Resources

Current regulatory resources for market conduct regulation vary among the states. The funding mechanisms available to regulators also vary. Regulatory planning and priorities will need to consider how to make best use of the resources available or that can be reasonably commanded. The recommendations of the NAIC's Resource Guidelines Working Group will have significant implications for how the adequacy of a state's resources will be judged. It is possible that some states will be judged to have inadequate resources devoted to market conduct regulations. This would raise the issue of how their resources could be increased. Better focus and greater coordination among states could yield significant efficiencies and enable regulators to direct adequate resources towards the most critical problems.

7. Costs of Regulatory Compliance

There are three categories of costs associated with regulatory compliance: 1) direct expenditures by insurers; 2) indirect costs; and 3) the economic value of services delayed or foregone. Consumers ultimately bear the burden of all of these costs. Hence, considering compliance costs in directing regulatory activities is not a matter of increasing returns to the owners of insurers. Rather, it is a matter of increasing the value or decreasing the cost of insurance services to consumers. Compliance costs should figure prominently in the cost-benefit analysis associated with determining regulatory objectives and how best to achieve them.

8. Coordination of Market Conduct and Financial Regulation

While most would recognize that it is vital that market conduct and financial regulators communicate effectively with one another, we do not believe that it is consistently done on a state or national level. Market conduct problems and activities may foretell financial difficulties or impacts of interests to financial regulators. Similarly, financial troubles may suggest the need for market regulatory action to protect consumers. An ideal regulatory scheme will foster such interchange of information on both a state and national level.

PART II – RECOMMENDATIONS

I. RECOMMENDED MARKET CONDUCT SURVEILLANCE SYSTEM REFORMS

Before describing our recommended reforms for the U.S. market conduct surveillance system, we want to inform the reader of two important matters. First, we begin with a brief restatement as to how and why we arrived at these suggestions, which are presented in greater detail in the first part of this report. Secondly, we explain why our suggestions are presented in a less than fully developed fashion.

Underlying our recommendations is the fact that circumstances have changed dramatically since the early 70's, when McKinsey & Company first recommended to the NAIC that market conduct surveillance activities should be separated from financial surveillance activities. At the time, financial examinations were generally the sole component of surveillance activities, thus market conduct related examination steps were separated from those that were part of financial examinations. As a result, Mckinsey's recommendation focused on market conduct examinations and not on a surveillance system.

One of the dramatic changes since the 1970's is that insurers have significantly and continually increased their attention to compliance matters and fair treatment of policyholders. Litigation, court judgements, awards and fines against a few have caused most insurers to take dramatic steps to avoid these problems and the resulting damage to their reputation and franchise value. Every well-run company today has a chief compliance officer or similar position, written policies and procedures for all compliance functions and a comprehensive support structure for effective implementation. This is not to say that mistakes, errors and non-compliance no longer occur, since they do. It is an attribute of matters handled by humans. Also, society's view of trade practices change over time. Race-based rating once deemed necessary to establish adequate rates is rightfully no longer tolerated. Companies that refused to underwrite business based solely on race are not condoned any longer. But, an effective compliance program will minimize such problems and remediate them when found. We do not believe that a market conduct surveillance system should exist to perform what amounts to "quality control" functions (i.e. identifying and correcting all transaction errors) for insurers; however, in large part this is what the present system does.

To paraphrase a hackneyed phrase "focusing more on the trees than the forest" is certainly an applicable description of the current system. But well-established bureaucracies are loath to change without strong impetus from public policy makers – in this case, state legislators. While the NAIC has taken up the market conduct reform banner, vested regulatory interests are minimizing the proposed reforms, as will be mentioned later.

Some will criticize our proposals as either impossible to achieve because of the differences in state laws or because we have failed to recognize that differences exist. Setting aside the question of whether the differences are essential or merely preferences, those that harbor these views have failed to grasp the goal of this effort – establishing a high standard of performance on insurers and regulators that oversee them. Market conduct surveillance should have as its goal, objective and purpose – creating an environment that results in ethical behavior and a proper corporate culture and philosophy reinforced by standards, systems and controls that seeks to achieve not only compliance with law, but fair treatment of policyholders in accord with the insurance contract. Such an approach as we will later describe is being pursued by other regulatory bodies.

With most state governments currently suffering from budgetary problems, this should provide further motivation to have a market conduct monitoring system that makes better use of limited resources by 'working smarter,' being more agile and relying on insurers to do their part.

Our charge was to develop the essential elements or general nature of a new market conduct surveillance system based on our Phase I findings, our knowledge of the industry and criticisms of the present system. We do not believe these recommendations represent the final word or view on the subject, but rather it is hoped that it will help the ILF, NCOIL and others to develop appropriate public policy in this important area of regulation. Therefore, our recommendations are not presented in a fully developed fashion. If these recommendations are deemed worthy of pursuit, the steps toward implementation outlined in this report can be commenced and the specific details of the elements of the new system can be determined.

Throughout these recommendations, we use the word 'compliance' by which we mean respecting all regulations and laws, treating policyholders and claimants fairly, promoting ethical behavior and following business practices that a reasonable and informed person would expect.

A. Overview of Key Elements

This section of the report details the general nature of the key elements of our recommendations for reforming the market conduct surveillance system. We believe that these changes will result in a system that is more effective, efficient and cost beneficial to all stakeholders – consumers, the insurance industry and state government.

Our recommendations include the following key elements each of which will be discussed in the sections that follow:

- Vest the domiciliary state with primary responsibility for performing market conduct surveillance of an insurer or a group of affiliated insurers. (See Section B)
- Enhance the NAIC's National Complaint Database, improving the information available to consumers as well as a valid tool for market conduct surveillance. (See Section G).
- Develop guidelines to be promulgated by insurance regulators, which describe standards for an insurer's compliance program, including systems and controls that will seek to ensure compliance with the laws and regulations and fair treatment of policyholders and adherence to contract terms. (See Section C)
- Conduct mandatory periodic communications between compliance officers of insurers and market conduct regulators to discuss relevant new laws and regulations and their interpretation, problems encountered in market conduct examinations or otherwise, and recent enforcement actions. (See Section D)
- Continue to use the market conduct examination as a key regulatory surveillance tool, but limit its use to insurers with actual or perceived problems. Consistent with our prior

recommendation, the examination will be conducted by the domiciliary state of the insurer (or the state in which the largest number of a group of affiliated insurers is domiciled). Non-domiciliary states will designate an 'association reviewer' to oversee the conduct of the examination. (See Section B)

- Embed market conduct surveillance into other regulatory functions. (See Section E)
- Create a National Market Conduct Oversight Committee to maximize interstate communications, cooperation and coordination. (See Section F)
- Develop a model law on market conduct surveillance which will create a statutory framework for this activity and will be predicated upon the recommendations we have made. (See Section B)
- Encourage adoption of the model statute to protect the confidentiality and privileged status of self-evaluation audits and independent assessments. (See Section I)
- Reward companies that participate in independent standard setting and assessment programs. (See Section H)

Transforming the system in the fashion described will accomplish the objectives stated earlier and which are discussed further in Section II and the deficiencies in the current system which are set forth in Section IV. A word about implementation and next steps is in Section III.

B. MODEL LAW ON MARKET CONDUCT SURVEILLANCE

A detailed discussion of our recommended reforms begins with a model law on market conduct surveillance, including examinations which will contain many of the reform elements we suggest.

As we learned during Phase I of our report, only two states have statutes which specifically address market conduct surveillance or examinations. In both cases, the law only addresses market conduct examinations, but does so in a very limited fashion. We firmly believe this is an obvious deficiency that needs to be corrected. The lack of a specific statutory foundation for this activity undoubtedly contributes to the faults and problems of the current system.

The absence of legislative direction has permitted market conduct regulators to decide the "what, when and how' of surveillance.

While it is beyond the scope of our work to prepare a draft of the model law envisioned, we set forth below our thoughts on the essential elements, and a brief discussion of such provisions to the extent they are not referenced in other parts of our recommendations.

1. Key Elements of the Law

Set forth below are our thoughts on this new model law which will not only establish a scheme for regulators to follow, but equally important it will be one established by state legislators. As we observed in the earlier part of this report, the extent and nature of market conduct surveillance in a given state results not so much from legislative determinations, but the attitudes of insurance department market conduct personnel.

The various sections of this law and its content are as follows:

- The "Purpose" Section should contain the following elements:
  - To create a system for identifying, assessing and prioritizing market conduct problems.
  - To create a mechanism for minimizing market conduct problems and a means to remedy significant market conduct problems.
  - To create a program for complete communication and coordination among states to make the most effective use of resources.

- A "Market Conduct Examination" Section - since this part is extensive, the recommended provisions are set forth below in item 2.

- "Participation in the National Complaint Database" Section - The law will require the Department of Insurance to collect and report complaint data to the NAIC for inclusion in the National Complaint Database (NCD), providing the database meets specific attributes. Additionally, this provision should require the Department to collect and maintain complaint information in a manner that meets all of the requirements of the NCD. Rather than just referencing the NAIC's database, we believe it would be appropriate to legislatively define what the qualities of that system need to be for the regulator to participate.

- "Insurers' Compliance Systems And Procedures" Section - The law will require the Department of Insurance to promulgate by regulation or bulletin the standards for an insurer's compliance program, including systems and procedures. Insurers will be required to certify periodically whether their program meets the standards or identify elements not met[14].

- "National Market Conduct Oversight Committee" Section - The law will require the Department of Insurance to participate and share information with an NAIC's National Market Conduct Oversight Committee (a committee recommended by this report), providing the committee's procedures meet certain requirements

Again, we expect the statute to define the attributes for this committee in order for the regulator to participate.

- "Communication" Section - This will require the Department of Insurance to conduct periodic meetings with the industry covering new laws and regulations, enforcement actions and related information.

- Other – we suggest that consideration be given to the inclusion of a 'whistle blower' provision in the model law. Such a provision was included in the Sarbanes-Oxley law. We also observe that some of the most noteworthy insurance market conduct abuses were first identified by present or former employees or agents. On the other hand, we suspect that certain 'false alarms' have resulted from disgruntled or ill-informed present and

[14] It is noted that the Senior Protection in Annuity Transactions Model Regulatory proposed by the NAIC in 2003 requires an insurer to establish and maintain a compliance program and sets forth provisions for such a program.

former agents and employees. We recognize that this is a potentially controversial and complex suggestion that deserves careful and thoughtful consideration. Further, we note that if it is pursued an appropriate contact person or unit at an insurance department will have to be identified with proper training on handling such information.

2. Key elements of the market conduct examination law envisioned:

a. "Examination Power and Authority" Section:

- The purpose of this Act is to provide an effective and efficient system for examining the market conduct activities and affairs of insurers' transaction business of insurance in this state. The provisions of the Act are intended to enable the Commissioner to adopt a flexible system of examination.
- In lieu of an examination under this Act of a foreign or alien insurer licensed in this state, the Commissioner shall accept an examination report on the company as prepared by the insurance department of the company's state of domicile if that state has adopted a market conduct surveillance law substantially similar to that contained in the laws of this state.

b. "Scope and Notice" Section

- Examination authority granted to one or more examiners designated by Commissioner.
- Company should receive a notice of examination at least 30 days before the examination is scheduled to commence, unless circumstances dictate otherwise.
- Scope of examination – As discussed later under "Timing," it is contemplated that all examinations will be 'targeted' and not 'periodic' or 'comprehensive.' As such, the focus will be the specific trigger, i.e. concern or problem that prompts the examination.
- The examination will focus on general business practices and compliance activities and not random errors.

c. "Access to books and records, employees, officers and directors of the company" Section

- Free and full access during business hours
- Power to issue subpoenas and examine persons under oath.

d. "Examination Report" Section

- Provisions in the NAIC's Model Law on Examinations may be used for this section.
- Action oriented reports.
- Insurer's comment letter included in report.
- Timely and deliberate process for preparing and releasing report with adequate opportunity for the insurer to respond to the findings of the report before it is released.

e. "Conduct of Examination" Section

- Field examinations used when 'desk' audits or 'calls' for information are not sufficient
- Examiners shall prepare work plan and budget.
- Budget (time and cost) shall be showed to the company under examination.
- Exit conference at conclusion of examination with the insurer.
- Use of NAIC Market Conduct Examiners Handbook.

Ideally, this manual should be universally used by market conduct examiners but this does not appear to be the case currently. This is contrary to what occurs with the Financial Condition Surveillance Handbook. The reason for this is obvious, the language and cavets set forth in the manual do not seek to create uniformity or sound standards. Thus it emphasizes the need to modify what the manual suggests, "to reflect each state's own laws, regulations, audit procedures, examination scope, and the priorities of examination." Significant variation in state examination procedures are not justified.

The goal of the new system will be to bring uniformity to the examination and monitoring process through a revamped and renamed 'Market Conduct Surveillance Handbook' that will be referenced in the statute as a source to observe.

f. "Conflict of Interest" Section

- Provisions in the NAIC's Model Law on Examinations may be used for this section.

g. "Examination Fees" Section

- The cost of examinations levied against an insurer should be incorporated here and be consistent with that otherwise authorized by law.

h. "Immunity" Section

- Provisions in the NAIC's Model Law on Examinations may be used for this section.

i. "Frequency and Timing of Examination" Sections

- The Commissioner should be authorized to conduct an examination whenever it is deemed necessary; however, the statute should enumerate what should cause or conditions that would trigger an examination, such as:

  Single Insurer Issues
  - Information from financial examinations
  - Complaint levels as reflected by the National Complaint Database.
  - Failure to file compliance programs.
  - Incomplete or inadequate compliance programs
  - Lack of participation in self-regulatory organizations.
  - Lack of independent assessment of compliance functions.

Industry Wide Issues

- Issues involving a number of companies where there is an indication that certain common practices may violate state regulations or that otherwise require regulatory attention. Here again we must distinguish between practices that constitute violations of the letter or spirit of regulations and not practices that some may dislike but that are in compliance with regulations.

j. "Examination Coordination with Other States" Section

The Department of Insurance shall participate in the NAIC's 'Association Reviewer' Program. This program is described later in these recommendations. This section would provide for the qualifications and compensation of the 'Associate Reviewer,' when designated to serve on the examination of a domestic insurer that conducts business on a multi-state basis.

k. "Examiner Qualification" Section

The examiners appointed by the Commissioner shall be qualified by education, experience and/or professional designations to perform examinations.

As we noted in our Phase I report, contract examiners did not appear to be a significant problem. We believe that concern of some is not related to contract examiners per se, but rather the scope of the work they are asked to do. We expect that our new system will rectify that concern. We recommend that the statute permit insurance departments to supplement their staff with outside professionals when necessary and prudent.

l. "Enforcement" Section

- Companies should be encouraged to self-police, self-report and remediate problems detected. Those that do should not be penalized.

- Fines and penalties should be consistent, reasonable, and justified.

3. Development of a classification system for 'targeted' examinations.

The type of market conduct examinations we propose to be performed in our suggested surveillance system is limited to 'targeted' examinations, and not routine, periodic comprehensive examinations. We suggest such an approach for several reasons.

First, we believe that such an approach is the best and most efficient use of limited state resources. Additionally, we believe that periodic comprehensive examinations based principally on the lapse of time imposes an unnecessary burden on insurers and unneeded cost to state government. As we noted, in our Phase I report, neither the NAIC nor the individual states have demonstrated that routine periodic examinations are effective in protecting consumers and, in fact, no one has developed methods of measure to demonstrate that they are effective. Some regulators justify such examinations are necessary because financial examinations are conducted on a periodic basis. We do not feel that such an argument or position is supportable. The various internal and external factors that can affect financial standing are not present with the market conduct performance. This is not to say that financial difficulties cannot cause market conduct problems, but we believe such a condition can be detected by means other than periodic comprehensive examinations.[15] In fact, monitoring of complaint activity, marketplace intelligence and other steps will likely result in more timely detection of problems. To achieve this result, regulators will need a classification system to identify companies for targeted examinations based on key indicators of trouble or potential problems.

[15] Of course, if financial analysis indicated that an insurer was in financial difficulty, this could prompt a closer review of certain areas of activity, such as claims adjustment and payment, to determine if the financial problems were leading to market conduct violations.

The matrix which follows is a simplified demonstration of what we envision based on external and internal indicators:

Internal Indicators	External Indicators: Not Concerning	External Indicators: Concerning
Strong	Lowest Priority	Medium Priority
Weak	Medium Priority	Highest Priority

We define 'external' and 'internal' indicators to include, but not limited to the following:

External

- Indications from the NAIC's National Complaint Database
- Marketplace intelligence information
- Determinations of the NAIC Market Conduct Oversight Committee
- Information from financial examination

Internal

- Significant change in ownership, management, lines of business, etc.
- Membership in standard setting organizations
- The strength or weakness of insurer's compliance system
- The corporate attitude and culture toward compliance and fair treatment of policyholders.
- Independent assessments

Of course, as previously mentioned, there may be other issues that may prompt a 'targeted' examination including industry wide issues. Evidence of unfair practices in areas such as privacy, underwriting, and money laundering would illustrate the latter.

4. Association Reviewer for Market Conduct Examinations

Certainly one of the strengths of the state regulatory scheme is the checks and balances it provides over insurers that do business in more than one state. Ideally, this condition should exist in the reformed market conduct examinations scheme.

As noted in Phase I of our report, many believe there is a duplication of effort and overlap by the various state insurance department performing market conduct examinations. Insurers believe that the states fail to adequately coordinate their market conduct examinations. During the course of our work, we received anecdotal reports that it was not uncommon for an insurer to be examined by several insurance departments at the same time, or in close proximity to one another - each presumably pursuing the same objective. This was confirmed by data on the number of examinations performed each year and responses to our survey of regulators and insurers. The incidence of multiple examination contrasts with financial examinations where coordination has existed for a long period of time, thus avoiding unnecessary duplication.

While we have recommended that the domiciliary state should assume the responsibility for market conduct surveillance, we believe it would be desirable to have a procedure whereby the non-domiciliary states can participate and oversee an examination being conducted of a multi-state insurer.

Therefore we recommend that a new examination position be created, that being 'Association Reviewer.' Essentially, the duties of this position would be: 1) to oversee the domiciliary state's work to ensure that it was properly done and to ensure that the examination report fully and completely sets forth appropriate examination findings; and 2) perform certain tasks that the non-domiciliary states want performed that is not being done by the domestic state.

Of course, not every examination of a multi-state insurer will necessitate the participation of an Association Reviewer. We recommend that appropriate criteria, e.g. criteria based on premium volume, indications of patterns of violations in non-domiciliary states not found in the domiciliary state, etc., be established to determine when an 'Association Reviewer' is required.

Naturally, we would expect persons seeking to be 'Association Reviewer' would be well qualified to perform the duties and responsibilities of the position.

C. DEVELOPMENT OF A GUIDELINE DESCRIBING STANDARDS FOR AN INSURER'S COMPLIANCE PROGRAM

The market conduct surveillance system we envision is based on a more proactive and forward looking regulatory approach with emphasis placed on the responsibility of an insurer's senior management to run their business effectively and in a way that does not harm consumers. Regulators will provide guidelines on the standards required of companies in building and maintaining an effective compliance program that identifies, measures and prioritizes related risks. The bedrock of a company's regulatory relationship will be an examination of the company's basic compliance operation. Does it meet the criteria set forth by regulators for an effective compliance program? While volumes have been written on the components of a comprehensive compliance operation, there are several key standards which would serve as the framework for insurers in establishing an effective compliance program. In this new system, chief executive officers of insurers would certify to regulators that their compliance program meets these standards, or identify standards not met. A company could choose to add credence to its certification by obtaining the opinion of an independent party.

What follows is a brief description of the topical areas the regulatory guidelines should cover:

Compliance Standards and Procedures

It is central to any compliance operation that the insurer implements the myriad required compliance functions. These include, but are not limited to, regulations addressing: licensing and appointment; correspondence and sales material review; complaint handling; training, form filings and supervision and monitoring of registered individuals and offices. To stay abreast of these changing and evolving regulations, companies need to identify and track the promulgation of new laws and regulations and track implementation of required procedural changes.

Ideally, the company will have written policies and procedures for all compliance functions, not just those contained in compliance manuals required by law. These procedures should be communicated to all appropriate individuals inside and outside the company, adequate training should be coupled with this communication, and individuals charged with compliance implementation should be supervised.

Compliance operations do not work in a corporate vacuum and compliance policies should emanate from a compliance mission and vision statement that is derived from the company's overall corporate goals and objectives. By connecting compliance policies to critical corporate governance principles, compliance procedures become a means for furthering the broader corporate agenda.

Oversight by High Level Personnel

A review of compliance effectiveness must result in a high level evaluation of the compliance operation by senior management and the board of directors. Is corporate management setting the corporate "tone" for compliance? To be effective, senior management must consistently and continuously communicate its position regarding compliance and support this position with concrete visible actions. This support includes, fully integrating compliance efforts into the basic business operations of the company.

Separate Implementation, Supervision and Monitoring Functions

Adequate supervision by management of the compliance procedures starts with clear articulation of the compliance procedures to be implemented. Apart from implementation and supervision functions, there should be comprehensive monitoring of the compliance efforts. The monitoring function should be handled by individuals who are not aligned with the business unit that is performing the compliance and supervision functions. Consequently, if the compliance function is being performed by individuals in the compliance department (e.g. sales material review), monitoring should be performed by a separate department (e.g. internal audit). Ideally, monitoring includes determining if the compliance policies and procedures are linked to corporate objectives, whether there is effective communication of these policies to appropriate stakeholders, and whether training is provided to individuals who are responsible for implementing and supervising the compliance functions. Ultimately, a compilation of the monitoring results should be reported to senior management and the board.

Multiple Avenues for Reporting Compliance Concerns

One of the challenges to making an insurance company compliance program viable is gaining the trust of employees responsible for the marketing and administration efforts and the producers who sell the products. It is important that a number of options are offered to address the full range of potential compliance issues. Robust compliance programs often have a hierarchy of people and avenues to report concerns to, including: someone with established respect and trust in the functional area; any supervisor or manager; a compliance officer or manager; the legal department; an ethics officer; a toll-free helpline, affording the option of anonymous reporting; and a secure email address, specifically for compliance issues.

***Consistent Enforcement of Compliance Standard*s**

Effective compliance programs require meaningful consequences for individuals who choose not to comply. The consequences should be fully articulated in a comprehensive disciplinary policy or in the company's code of conduct or ethics. These might include progressive disciplinary actions linked to violations of both the letter and the spirit of distributed compliance policies and procedures. It would be important for the company to work with counsel to establish appropriate due process procedures and, where warranted, an escalating appellate, or review process. The disciplinary process must be enforced in a consistent manner to avoid any erosion of confidence in the compliance program.

Established Guidelines for the Investigation of Compliance Issues as They are Reported

It is beneficial for companies to develop a formal vehicle to record and track compliance issues as they are reported. It is critical that the appropriate people with the requisite authority and experience perform investigations and that employees are aware, through training and the company code of conduct, that they are required to fully cooperate in any investigation of alleged misconduct.

Reasonable Steps to Respond to and Prevent Further Similar Offenses

It is critical for an insurer's compliance department to track and analyze the following data:

- The date a compliance issue or concern was reported.
- Whether it was reported anonymously or not and with follow-up contact information, if available.
- Details of the compliance issue.
- To whom the issue or concern was forwarded for further investigation.
- Who is responsible to resolve the issue.
- The anticipated follow-up date.
- Acknowledgement of the investigation process/status to the person who reported the issue.
- Actions taken to resolve the issue.
- Follow-up correspondence, if appropriate.
- Closure status.

The ability to track and trend data by producer, agency and marketing organization helps the compliance department in early detection of potential market conduce issues. Individual producers or entities that statistically fall outside of established norms warrant increased attention and heightened supervision. Companies should not wait for regulators to uncover potential violations.

Clear and Consistent Communication to All Stakeholders

Clear and consistent communication is the cornerstone of any compliance operation. It is essential for those in control of a compliance program to keep senior management and the board of directors fully informed of compliance issues. It is wise to inform regulators of efforts to address issues identified in the past.

Compliance Operations Evolve as the Companies' Products and Operations Change

Progressive compliance departments institute a routine review of the compliance operations at regular intervals and have a process for off-cycle review or specific procedures when warranted by indications of undesirable trends or events. Compliance programs require modification as the company's products and operations change.

Prompt and Full Cooperation with Regulators

A company's level of cooperation during an investigation will be an important factor when considering an appropriate response to identified wrongdoing. Obviously intentional acts to circumvent laws and regulations, or gross negligence should be penalized harshly.

D. COMPANIES WILL BE PROVIDED "PLAIN LANGUAGE" EXPLANATIONS OF ANY NEW LAWS OR REGULATIONS AND WHAT IS REQUIRED TO IMPLEMENT THEM IN A COMPLIANT WAY IN PERIODIC SESSIONS WITH INSURER'S COMPLIANCE OFFICERS.

The marketplace is leading the way into new lines of business, new combinations and new products, and regulators must keep up to ensure that market innovations do not conflict with the public's basic interest in safety and stability. New laws or regulations frequently require interpretation and 'plain language' explanations. Effective communication between regulators and insurers regarding these developments is absolutely essential.

In this new surveillance system we are recommending that companies be provided practical "how to guidance" in building and maintaining effective compliance programs. Guidelines describing standards for an insurer's compliance program will allow companies to identify, measure and prioritize the compliance risks associated with the company's unique business environment. No longer will the system simply ferret out and punish wrongdoers; rather it will endeavor to eliminate or minimize such problems.

In this new paradigm of market surveillance, companies not only will be given best practice guidance on what a model compliance structure looks like, but insurers' compliance officers also will engage in mandatory, periodic dialogues with regulators to discuss relevant new laws and regulations and their interpretation. When laws or regulations are changed, companies will receive guidance on what this means for their company and how they must implement changes to remain in compliance. Plain language drafting and "compliance handbooks" would allow insurers to be fully informed as to how statutory and regulatory changes will affect compliance and market conduct examinations.

Companies and regulators should work together to achieve a more proactive, forward looking regulatory approach with emphasis placed on the responsibility of senior management to run their business in compliance with regulatory requirements. Companies will know how to be compliant. With enhanced communication, regulators can solicit guidance and industry feedback on problems encountered during the examination process, as well as any enforcement actions.

This same proactive, forward-looking regulatory approach can be found in other regulatory arenas. Regulators appear to be shifting from prescribing specific behaviors or controls to articulating the principles or guidelines for a company to follow and then allowing the company to develop effective controls for meeting these principles or guidelines.

By way of example, there has been a sea change in the regulatory approach adapted by the Financial Services Authority since it became the U.K.'s sole financial services regulator. By building a more focused, risk-based approach to regulation, firms are incented to reduce their regulatory burden by taking action to reduce certain risks within their organizations. This risk-based approach changes the dynamic of the regulator-firm relationship, allowing firms to shift their focus from simply avoiding regulatory scrutiny and penalties and instead direct their efforts to embedding compliance within their organizations. This approach is grounded in making sure that financial institutions fully understand the FSA's risk-assessment framework.

Another clear example is the recently proposed anti-money laundering laws for the insurance industry. The proposed rule, for insurance companies, concerning Section 352 of the USA PATRIOT Act, reads, in part, as follows:

> *Each insurance company. . . shall develop and implement a written anti-money laundering compliance program reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities.*

Beyond some very broad directives and components, the rule is silent as to any required specific program elements. The minimum requirements specified simply state that the anti-money laundering program should:

> *Incorporate policies, procedures and internal controls based upon the insurance company's assessment of the money laundering and terrorist financing risk associated with its products, customers, distribution channels and geographic locations.*

Commentary associated with these proposed rules stresses the fact that each company will need to design controls that are specifically tailored to manage the company's identified compliance risks that are associated with the company's unique business environment.

In another example, the publication of interpretive bulletins, along the lines of the NASD's Notice to Members, appears to work very well in helping companies understand the intent and spirit of the statutes and regulations being supervised by the NASD. While a specific rule may state a broad, intended outcome, these interpretive bulletins go into much more detail with regard to the goals and objectives of the rule. Using examples as guidance, the bulletins help companies understand the types of controls that the regulators might expect to find during an examination.

Pursuant to the Regulatory Improvement Act of 1994, the banking industry has conducted a systematic review of new regulations and policies to reduce duplication, inconsistencies and unnecessary costs. The cornerstone of this effort at the FDIC has been to not only use a risk-focused examination approach, but to solicit ideas from banks on how to improve the exam process and reduce the regulatory burden. Following each examination, examiners are required to document the bank's comments on the examination process which are then included in the confidential section of the examination report.

Clearly, these new approaches illustrate what could and should be done. Rather than examine whether a company has implemented regulator-designed controls, the examiner is going to have to determine whether the company designed controls are reasonable given the company's risk environment and the state of compliance programs in general. This should alter the focus of an examination away from random errors and unintentional failures to a company's general control environment to determine whether the company implemented controls that are reasonably designed to manage identified risks.

E. COMPLIANCE REVIEWS AND CONCERNS WILL BE EMBEDDED AND INTEGRATED INTO OTHER REGULATORY FUNCTIONS.

A review of a company's compliance programs/internal controls should be integrated into the comprehensive review regulators conduct during the admission process. Closer scrutiny of a company's compliance program by regulators in all states during licensing will provide strong incentive for companies to "get it right the first time."

Early detection of improper market conduct activities among companies already operating in a jurisdiction could be achieved during regulatory reviews conducted as a result of change of management, change of ownership, entering into new lines of business, or change in compliance patterns.

F. A NATIONAL MARKET CONDUCT OVERSIGHT COMMITTEE WILL FUNCTION AS A WAY FOR REGULATORS TO DISCUSS AND IDENTIFY PROBLEM COMPANIES

States have a mutual interest in the proper and efficient regulation of multi-state insurers. This is true for all aspects of regulation, including market conduct. Historically, the recognition of mutual interests has been greater for solvency regulation than for market regulation. However, the evolving nature of insurance markets and regulation indicates the need to extend this perspective to market regulation. States' shared interests in market conduct regulations arise from several factors including: 1) the interaction between an insurer's financial condition and its market behaviour; 2) the effect of market regulation on insurers' efficiency and ability to serve consumers in various states; and 3) the extension of market conduct problems across state boundaries. Also, significant economies of scale can be reaped from closer state collaboration. Further, the changes to market conduct regulation recommended in this report, such as the reliance on the domiciliary state, will increase the importance of interstate coordination.

Different mechanisms should be used to enhance interstate coordination. The present mechanisms – the advisory role of NAIC market conduct committees and market conduct services provided by the NAIC – are inadequate to achieve the level of coordination needed. A proposal to establish a market conduct accreditation program in the early 1990s was rejected at the time for reasons that do not seem to have the same validity today, especially if the recommendations in this report are implemented.

Still, a market conduct accreditation program would require considerable deliberation. We recommend establishing a National Market Conduct Oversight Committee that would have several important responsibilities in coordinating interstate activities on market conduct regulation. The role and responsibilities of the Committee will be analogous to certain other NAIC committees responsible for coordinating interstate activities, such as the Financial Analysis Working Group. The Committee's responsibilities would include:

- Monitoring and reporting on state implementation of the new market conduct system and the performance of the new system and the states.
- Managing interstate communication and coordination.
- Facilitating discussions of and drawing state attention to significant market conduct issues and problems and entities that warrant state investigation.
- Assisting domiciliary regulators in conducting examinations of multi-state insurers.
- Identifying needed changes to the market conduct system and related laws, regulations and other mechanisms for consideration by the appropriate NAIC committees.

The role and responsibilities of the Committee imply that it will need some set of standards and guidelines by which to evaluate state performance and carry out some of its other functions. The elements of the new system and its specific design will be a significant source for Committee standards and guidelines. Whether there will be a need to go further and develop a more comprehensive accreditation program could be determined after the Committee's effectiveness and the performance of the new system are evaluated.

It seems appropriate that the state members of the Committee would be able to represent the full scope of states' interests in market conduct regulation. At the same time, all states should have ready access to the Committee and participate in discussions that affect their interests. Also, consumer and industry representatives should be able to bring issues and concerns to the Committee.

G. A National Complaint Database will be enhanced and improved for the use of regulators, companies, and consumers

Effective use of complaint information at a state and national level will be critical to the system for market conduct regulation recommended in this report. It is clear that "a" National Complaint Database will be an important component of the new system for market conduct regulation. A National Complaint Database that aggregates complaint data and measures it in a way that is valid and useful to regulators and consumers will be required. The design of, access to, and state input into and use of the database will all be important.

The NAIC currently manages a National Complaint Database that has improved over the years but will require further improvement to serve the functions required. The database is a component of the NAIC's online Consumer Information Service (CIS). In general, there appears to widespread support for the concept of the database. However, there have been some deficiencies, including the level of state participation. Some states do not participate in the database and some of the states that do participate do not provide data in a form that fully conforms to the design of the database, such as the way it categorizes complaints and their final disposition. Clearly, all states will need to participate adequately to achieve the objectives of the new system. What constitutes "adequate participation" is discussed further below.

Design, access and use also must be evaluated and their interaction recognized. Serious consideration of how to measure complaint characteristics will be required from both companies and regulators. Of course, a balance must be struck between the complexity and efficiency of a complaint database. We must also consider the needs of different users of the information – regulators, consumers, insurers and intermediaries. Regulators will need a database that alerts them to patterns of complaints that may indicate patterns of market conduct that warrant further investigation. Consumers should be able to view certain information on complaints to assist their choice process. Intermediaries have an analogous need in terms of their assistance and counsel to insurance buyers. Insurers also may be able to utilize the database to bolster their self-compliance activities.

Regulators will need to convey the best information on a timely basis so that all of these needs can be. This requires the design of measures that tend to be stable and meaningful. Many complaints do not involve regulatory violations or improper conduct on the part of insurers and intermediaries. This will need to be considered in how the database is designed and information is presented to minimize false inferences from the data. The current database does categorize complaints by their disposition, but in numerical counts of complaints against a company the database does not distinguish between complaints requiring regulatory or company action from other complaints.

There is also the issue of the compatibility of national and state databases. State systems will need to be configured so that each can input sufficient and consistent information into the national database on a timely basis. This would not preclude a state from collecting additional information that would be relevant to its regulatory framework. At the same time, each state system will need to meet certain common standards in order to be compatible with the national database. The reforms recommended in this report should aid compatibility to the extent that they result in greater uniformity among state market conduct regulatory systems. Also, state participation in the database would be one of the things that the national oversight committee would review in its monitoring and reporting activities.

The industry has urged regulators over the last few years to improve the current NAIC Complaint Database. Variances in the definition of "complaint," variation in how complaints are classified, and differences in how complaint data are used, etc., will need to be remedied in this new system.

There are also issues with respect to access and presentation of information. If certain types of information are considered "sensitive" from a regulatory perspective, it may be necessary to except this information from full public access. There may value and justification for an insurer or intermediary to access non-public information related to complaints against them. While they may receive such information in some form at a state level, access to national data would aid their ability to view patterns that may warrant their attention.

With respect to the presentation of information, the simple numerical tabulation of the complaints against an insurer is problematic. Even complaint ratios, e.g., complaints in relation to premium volume, can be misleading. Obviously, presenting information in a summary form necessarily results in some generalization. At the very least, numerical counts and complaint ratios should distinguish between complaints requiring correction of a company violation or a company error from other complaints. What will be appropriate to present to public users will require further discussion.

This discussion highlights the role of the consumer in market conduct regulation. As noted in Part I, better informed consumers are less subject to certain improper trade practices and more aware of company actions that warrant filing a complaint as well as actions that are proper. The NAIC's CIS appears to be a good start in this direction. In addition to providing information on complaints, it enables consumers to contact their state insurance departments online and also file complaints online if their state has an online system for filing complaints. Some states have fairly extensive consumer information and education programs and others do not. Consumer information and education should be approached strategically and state and national programs optimized in enhancing consumers' role in an improved market conduct regulatory system.

H. Insurance Company Self-Analysis and Self-Assessment Activities and Membership in Independent Standard Setting Organizations

Insurer self-assessment activities (either self critical analysis, retained independent assessors or membership independent standard setting organizations) to detect improper market conduct practices will be encouraged and rewarded in this new system.

For purposes of this discussion, "Compliance self analysis" relates to the actions a company takes upon the discovery of information that may lead to the conclusion that certain actions of the company, or agents representing the company, are not in compliance with state statutes or regulations including fair treatment of policyholders and delivering on promises made. These actions may or may not result in the further discovery that a consumer has been harmed in some manner. A "compliance environment assessment" involves a company's periodic review of the compliance controls which the company has designed and implemented to manage the company's known compliance risks.

Over the past several years an ongoing discussion has emerged regarding whether, and the degree to which, an insurance company's self-analysis and self-assessment of its market conduct activities provides a benefit to the consumer. While there are several issues involved in these discussions, at the crux of the matter is the primary question of whether state departments of insurance should be providing meaningful incentives to further encourage and provide an incentive for this activity. In our July 6, 2000 Public Policy Review, 85 percent of the insurers surveyed responded that they performed self-critical analysis or retained independent assessors (permanently or regularly) to detect improper market conduct practices. At the same time, 60 percent of the market conduct chief examiners indicated that insurer self-assessment activities such as internal audit and compliance reviews by outside experts would not influence the scope of their market conduct examination.

There are at least two potential benefits to promoting insurer self-assessment activities. One is to improve insurers' market conduct compliance, decrease the number of violations and complaints and better serve customers. The second would be reducing the scope of regulatory examinations and making more efficient use of regulatory resources. Most importantly, it would promote an attitude that is a company's responsibility to find and correct its market conduct violations pro-actively, rather than waiting for regulators to do so.

Adverse Compliance Event Analysis

This new market surveillance system assumes that insurance consumers are well served when an insurance company quickly detects and corrects situations that are potentially harmful to consumers. It is laudable when companies actively investigate adverse compliance incidents and move quickly to remedy both the underlying cause of the problem and any harm resulting from the problem. A second, and equally important, assumption is that regulators are most effective when they have a full understanding of a company’s adverse compliance events. Regulators need these facts if they are to fulfil those statutory requirements relating to the investigation and remediation of adverse compliance events.

Given these assumptions, it makes sense that states should create incentives that will encourage companies to actively seek out information that may lead to the discovery of an adverse compliance event, correct the control issues that may have led to the event, remedy any harm that may have been caused by the event and fully cooperate with regulatory authorities. Toward this end, states should explore how other regulatory bodies are providing incentives that foster and promote these desired behaviors.

In late 2001, the Securities and Exchange Commission quietly gave notice that it was actively promoting the activities discussed above. In an unusual step, the SEC issued a Section 21(a) Report, Release No. 44969, providing a detailed rational explanation why the Commission was not taking any enforcement action against a specific company for the actions of a former company controller that had knowingly engaged in wrongful behavior.

The Commission cited the company's proactive and cooperative efforts in explaining its position on the matter. Moreover, it used the company's actions as a basis for providing a framework that the Commission stated it would use in examining whether another company's actions would warrant a similar response. Specifically, the SEC outlined four general categories of company actions that the SEC would evaluate before it determined whether, and how, to take action against that company for a violation of federal securities laws.

The first of these categories concerned actions relating to self-policing. The SEC stated that it would evaluate whether a company's compliance procedures were designed to effectively control and identify potential compliance violations. By examining a company's compliance procedures and then looking at the specific violation, the SEC will infer whether a company's overall compliance operation is the result of a good faith effort to reasonably protect the investing public.

The second category concerned actions relating to self-reporting. The SEC explained that in the event of wrongdoing, it would evaluate the steps taken by the company to conduct a thorough investigation of the nature, extent, origins, and consequences of the misconduct. The SEC will also evaluate how promptly, completely, and effectively senior management disclosed the misconduct to the board, the public, and regulatory bodies.

The third category concerned actions relating to remediation. The SEC will determine whether a company fully identified and sought to understand the effects and extent of any misconduct and how it addressed its findings. This analysis will include an examination of how the company handled those involved in the wrongdoing as well as how it addressed any harm that occurred to individuals.

The fourth category concerned action relating to cooperation. The SEC stated that it would examine the company's level of cooperation with law enforcement authorities, including providing the Commission with all information relevant to the underlying violations and the company's investigatory and remedial efforts. The SEC also explained that it will see whether, and how, the Company's senior management team directed company employees to fully cooperate in the Commission's investigation.

With publication of the Section 21(a) Report, the SEC sent an unmistakable signal that it was going to provide meaningful incentives for companies to quickly and openly respond to identified violations. It should be noted that the SEC made it very clear that it was not providing a way for company's to avoid liability and warranted sanctions. Rather, it stated that the degree of sanctions following the findings of liability could be mitigated by a company's proactive and cooperative actions. Clearly, it is the intent of the SEC to encourage companies to quickly analyze and positively deal with the disclosure of facts that may lead to the discovery of an adverse compliance event.

Conversely, it is not a stretch of the imagination to believe that companies might purposefully ignore the initial discovery of facts if the company believed its diligent, and good faith efforts would be ignored and that the only outcome for the company would be to face significant liability. Rather than provide companies with two negative consequences – "bad" if good faith efforts are undertaken and "worse" if good faith efforts are not undertaken and the facts still come to light, states should provide incentives for companies to act in a desired fashion.

Compliance Environment Self-Assessment

While it is important for a company to actively self-police, self-report, remediate and cooperate after the disclosure of facts leading to the discovery of an adverse compliance event, it also is important for a company to proactively evaluate its entire compliance environment, seeking ways to enhance controls to better manage compliance risks with the objective of limiting the instances of an adverse compliance event.

Similar to the discussion above, it is useful to outline certain background assumptions behind our ultimate conclusions. It is assumed that states require the implementation of compliance controls to manage the risk that certain activities could lead to an adverse compliance event. For example, a compliance control could state that: Advertising and sales material are reviewed and approved prior to release to help assure that consumers are not misled about a products benefits; and replacement statistics are maintained so that a company can prevent unwarranted replacements.

A company's compliance environment and self-assessment efforts benefit the consumer and incentives should be provided to promote these activities. Most companies will engage in these activities with or without state encouragement because it is the "right" thing to do and in the best interest of the company's customers and owners. However, many regulators and company officials believe that a cooperative effort between states and companies will go far in not simply providing encouragement for these assessment activities but in fostering an atmosphere that supports the development of imaginative, creative and highly effective controls.

While most companies engage in some form of compliance environment self-assessment activity, the coordinated and organized efforts of the Insurance Market Place Standards Association (IMSA) have taken the process to a new level. At the heart of the IMSA process, companies complete an exhaustive self-assessment of the company's compliance regime as part of the certification process.

IMSA's self-assessment element is intended to be an on-going evaluative process that spurs a company to the early identification of beneficial control modifications. The process might identify new risk areas requiring additional controls or the need to enhance the implementation of existing controls. Extending the concept of self-assessment, the IMSA process uses independent assessors to examine and evaluate a company's control environment. Fundamentally, the independent examination provides a means to verify a company's self-assessment. However, the independent examination also helps a company analyze whether its compliance program is fundamentally designed in a reasonable manner. Independent examiners understand the current state of compliance controls being implemented in the industry and can provide valuable insights as to whether a company's compliance program is using currently accepted compliance controls or whether enhancements and modification would be in order.

States can promote an insurance company's compliance environment self-assessment efforts in a number of ways including, but not limited to, relying on the results of the self-assessment in the examination process. It is beyond the scope of this section of the Report to discuss the arguments surrounding this form of incentive. However, there is an additional incentive that warrants examination. Currently, there is a fear by some companies that the self-assessment results may be used by regulators and consumers as evidence supporting company liability. Consequently, some companies have taken the position that the risk associated with a self-assessment may be greater than the benefits.

States seeking to support the self-assessment process need to assure companies that the results of this process will not be used to place the company at a significant disadvantage should the company discover and disclose compliance issues. Similar to the discussion above, a company's activities surrounding self-assessment, meaningful remediation and disclosure should act as real mitigation factors in a state's determination of an appropriate response to the disclosure.

In addition, as will be discussed in the next section, states seeking to promote self-assessment, as well as self-analysis, need to consider the benefits of passing self-analysis privilege legislation. This form of legislation would help remove a company's fear that its discovery and remedial efforts could be used to support findings of liability and the enforcement of sanctions.

Ultimately, a company's actions in self-analysis and self-assessment are beneficial to consumers and states should provide meaningful incentives to promote these actions. The system recommended in this report relies significantly on these self-policing efforts.

I. ENCOURAGE ADOPTION OF THE MODEL STATUTE TO PROTECT THE CONFIDENTIALITY AND PRIVILEGED STATUS OF SELF-EVALUATION AUDITS AND INDEPENDENT ASSESSMENTS OF COMPLIANCE PROCESSES AND QUALITY CONTROL MEASURES.

As we have observed, insurers are increasingly conducting aggressive self-audits for many legal and policy reasons. Assessments of compliance activities and related operational functions by independent third parties as a part of certification process, such as The Insurance Marketplace Standards Association or otherwise, are growing. This is a positive trend and public policy should encourage it. However, these types of critical analyses will not be done or not done as aggressively and effectively as they could be if reports, workpapers and related documents are not protected against disclosure to third parties. The issues involved are complex but important. For instance, regulators generally feel that they should have full access to any insurer document that they view relevant to their regulatory mission. An insurer's claim of privilege or confidentiality are often seen as "stonewalling" or impediments to the regulator fulfilling statutory obligations.

From an insurer's perspective, it wants to be able to safeguard the confidentiality of privileged, sensitive, competitively valuable or self-critical communications, so that it cannot be used against it in litigation or otherwise.

We recommend that the self-critical analysis privilege be established by statute and that states be encouraged to adopt NCOIL's Model Act on the subject as amended July 13, 2001.

II. RATIONALE UNDERLYING THE REFORMED SYSTEM BEING RECOMMENDED AND HOW MARKET CONDUCT SURVEILLANCE WILL BE IMPROVED.

A. THE INSURANCE INDUSTRY HAS CHANGED DRAMATICALLY SINCE THE 1970S, WHEN THE MCKINSEY STUDY WAS DONE.

This subject is discussed in the first part of this report

B. THE MAJORITY OF COMPANIES WANT TO BE IN COMPLIANCE.

Companies are under increasingly closer scrutiny financially, operationally, and from a compliance perspective. Insurers have become increasingly aware of the need to conduct self-critical analysis audits to determine their compliance with laws and regulations, and many insurers have committed significant time and resources to building an effective compliance operation. In part, this effort has evolved as a reaction to state insurance regulators who have become increasingly aggressive in market conduct exams but class action litigation, adverse court judgements and other related factors also have had a significant role. Yet, these efforts have been conducted without clear-cut standards from regulators for compliance operations or strong indications that they are necessary and important.

C. IN THIS NEW PARADIGM OF MARKET SURVEILLANCE, COMPANIES WILL BE GIVEN "BEST PRACTICE" GUIDANCE ON WHAT A MODEL COMPLIANCE STRUCTURE LOOKS LIKE.

Companies and regulators will work towards a proactive partnership to protect consumers by controlling market conduct. When laws or regulations are changed, companies will receive guidance on what this means for their company and how they must implement to be compliant.

D. THIS NEW SYSTEM IS BASED ON THE UNDERLYING PREMISE THAT INSURANCE COMPANIES ARE IN BUSINESS TO TREAT POLICYHOLDERS FAIRLY, AND ONLY COMPANIES THAT VIOLATE THAT TRUST WITHOUT REPARATION SHOULD BE PURSUED AND PUNISHED.

E. THIS NEW SYSTEM WILL BE PROACTIVE RATHER THAN REACTIVE. IT WILL PLACE EMPHASIS ON EVALUATING "PATTERNS" OF MARKET CONDUCT PRACTICE, NOT THE DETECTION OF INDIVIDUAL INCIDENTS OF DEFICIENCIES.

The approach currently used in market conduct exams keeps the relationship between the insurer and regulator solely at a transactional level. This new system would change the dynamic of the relationship between the insurer and regulator. Companies will be able to break out of the continual cycle of keeping pace with regulatory change and responding to regulators' requests, and instead will be able to focus on preventing market conduct failures and monitoring the internal controls and compliance structure in their organization. Companies will be evaluated on the compliance framework they are using.

F. THE NEW MARKET SURVEILLANCE SYSTEM WILL ENCOURAGE COMPANIES TO EMBED COMPLIANCE WITHIN THEIR ORGANIZATION IN SUCH A WAY THAT GOES WELL BEYOND THE OBJECTIVE OF SIMPLY AVOIDING REGULATORY SCRUTINY OR PENALTIES.

There will be meaningful incentives for companies to implement comprehensive internal controls and to commit to a compliant environment.

G. COMPANIES THAT HAVE ADOPTED A SOPHISTICATED APPROACH TO COMPLIANCE AND THE NECESSARY INTERNAL CONTROLS WILL RECEIVE LESS REGULATORY SCRUTINY.

An analytical risk-based approach shifts attention to those exhibiting the most egregious behavior. The new framework we are proposing would evaluate a company's compliance and internal control efforts before determining whether and how to take action against a company for any violations.

In today's environment, corporations worldwide are facing a watershed in recognizing the need for establishing management responsibility for risks and controls. The Sarbanes Oxley Act of 2002 enacted by Congress and signed into law has put a new focus on internal controls across the financial services industry globally. Sarbanes Oxley places responsibility for an effective control environment first and foremost with management. SEC registrants must comply with stringent internal control certification requirements. As a result, the "COSO" Framework (developed in the early 90's and the most widely recognized framework for evaluating internal controls for any organization) has been driven back into the limelight and has focused senior management's attention to the importance of internal controls.

The market surveillance system we envision would rely on an integrated view of controls across a company. Those companies with effective compliance structures and internal controls will receive less scrutiny.

H. THIS NEW SYSTEM WILL ACTUALLY ALLOW REGULATORS TO BE MORE VIGILANT AND TO PROVIDE QUICKER CORRECTION AND REMEDIATION.

III. IMPLEMENTATION OF THE NEW MARKET CONDUCT SURVEILLANCE SYSTEM – NEXT STEPS

Our recommendations are not an ad-hoc incremental process oriented approach to address the deficiencies and shortcomings of the current system. It is a dramatic rethinking of how the system should be designed. The interdependence of some of our recommendations further reinforces our view that a program of reforms should be implemented rather than arbitrary selection of some and not others. With this in mind, we offer the following suggestions for the next steps and implementation:

- We believe that the first place to start is the model law on market conduct surveillance. We have put forth our ideas for that statute in a general way; however, public policymakers will need to decide if this is the kind of surveillance system that would best serve the needs of insurance regulation in the U.S. and resolve certain primary issues that require early resolution – purpose, scope and general requirements. Support and consensus would have to be found for this system. Drafting could parallel consensus building.

- The second step would be the model examination law which is a part of the model surveillance law but can be temporarily set aside until the surveillance law is agreed to. It would be difficult and counterproductive to attempt to resolve its intricacies without having first established a general definition of the surveillance system.

- Next, the National Complaint Database and National Oversight Committee procedures could be established.

- At the same time, the Market Conduct Examiners Handbook will have to be revised to reflect the new system. In fact, we envision an entirely new manual, "Market Conduct Surveillance Handbook," that provides guidance and uniformity for the system we recommend. Standards for Insurers' Compliance Programs will have to be developed.

- Most importantly, market conduct surveillance personnel in insurance departments will have to be trained and instructed on this new system and its implementation. This process will not be dissimilar from what occurred when the McKinsey & Company recommendations for revamping the U.S. financial surveillance system for insurers was adopted by the NAIC in the 1970's.

Establishing a time line for all of the aforedescribed activity is well beyond our charge, but as we stated the first step is reach agreement on the model law for market conduct surveillance which we feel can be accomplished by the ILF and NCOIL by the end of 2003.

IV. EFFECT OF PROPOSED CHANGES

The chart on the following page identifies how our recommended changes to market conduct surveillance will overcome the deficiencies in the current system. The deficiencies are those we have identified in our Phase I and subsequent work, many of which have been recognized by the NAIC, consumer groups, insurance industry and others.

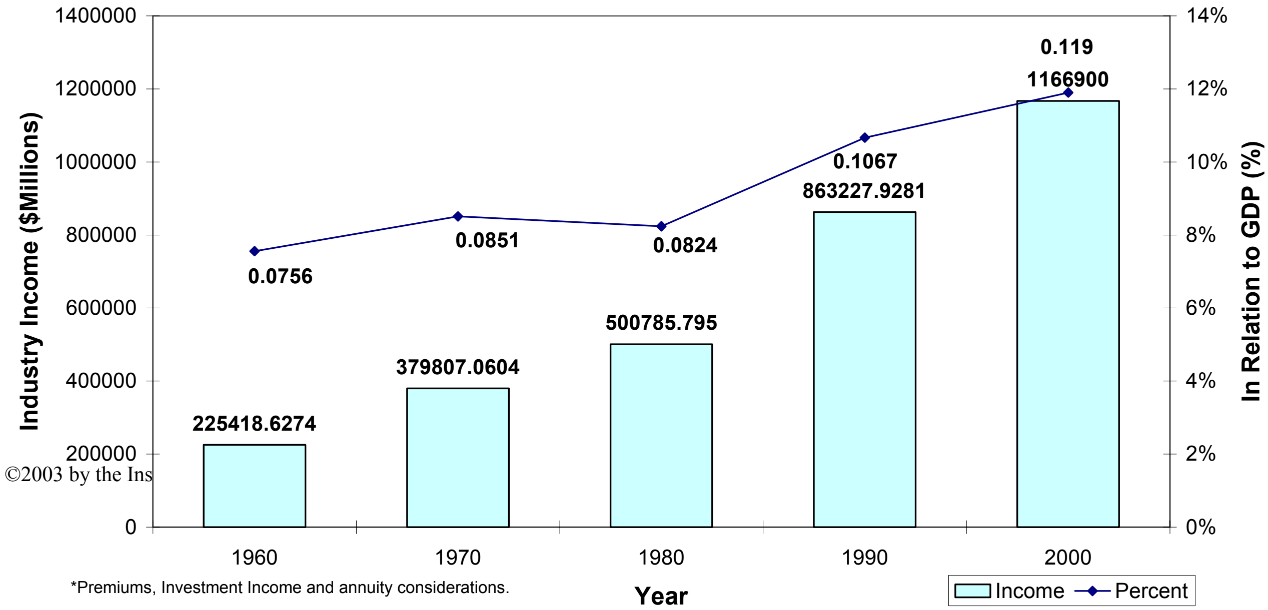
Deficiency	Met By
1. Failure to acknowledge insurers' compliance programs, self-assessment and independent assessment activities, membership in organizations that set ethical standards.	• Requiring regulators to establish standards for compliance programs. • Utilizing efficacy of compliance programs and assessment activities, as well as membership in standard setting organizations to determine examination scope and frequency.
2. Lack of a statutory basis through a model law for market conduct surveillance activities, including examinations which short coming fosters duplication of efforts, lack of uniformity, misguided efforts, etc.	• Establishing a model law on market conduct surveillance, including examinations which will serve as a national standard for such activities. • Putting state legislators in control of a regulatory process that some would say is 'out of control.'
3. Lack of coordination for multi-state insurers.	• Domiciliary state has principal responsibility for monitoring activities. • New position of 'Association Reviewer' is introduced to represent non-domiciliary states and provide and independent check on examination quality. • National Oversight Committee is created to exchange information, etc.
4. Focus of activities is on random errors and not general business practices.	• Examination will focus on systems, procedures and controls that seek to result in ethical and compliant activity and not seek to detect random and inadvertent errors or non-compliance.
5. Routine periodic comprehensive examinations are not needed or cost beneficial	• Providing only for targeted examinations. • Enhancing National Complaint Database to serve as an identification tool for targeted examinations.
6. Inadequate communication between 'regulator' and 'regulated.'	• Holding mandatory sessions between insurers' compliance officers and market conduct regulators to explain new statutes and regulations, recent enforcement actions and related matters.
7. No uniform and rational basis for enforcement actions including fines and penalties.	• Establishing requirements in the Model Market Conduct Surveillance Law.

Next, we list in the following chart how the NAIC market conduct monitoring reform efforts may address the identified deficiencies. To be fair, most of the NAIC activities in this area are 'work in progress.'

NAIC Activity	Deficiencies That May Be Corrected
1. Market analysis/market conduct annual statement	None
2. Uniformity in examination procedures	Unclear
3. Resource guidelines	Unclear
4. Interstate Collaboration	Number 3 (in part)
5. Market Information Systems	Unclear

EXHIBIT I-1

Figure I-1
Income (in $Millions) of Insurance Companies in the U.S.*
(In Constant 2000 Dollars) 1960-2000



*Premiums, Investment Income and annuity considerations.

Source: ACLI, A.M. Best, Bureau of Economic Analysis and NAIC

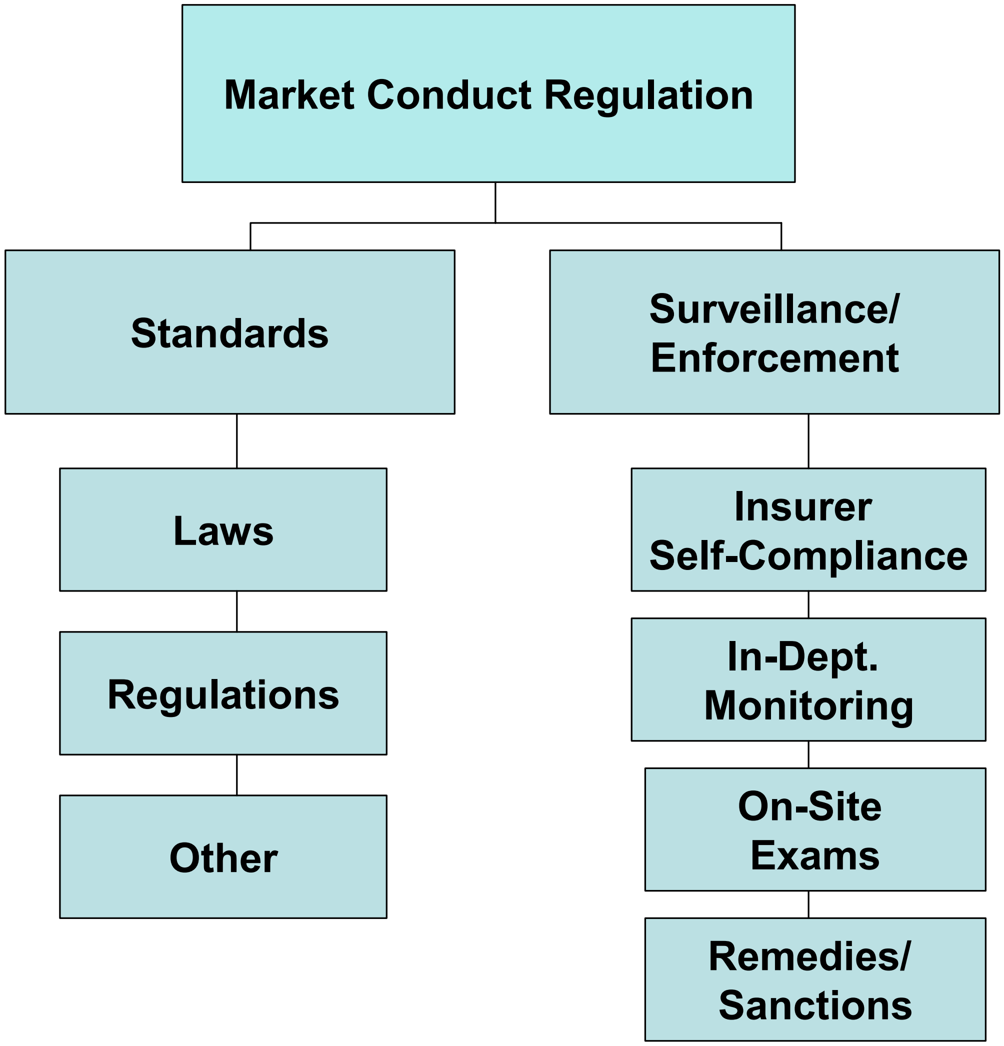
EXHIBIT I-2

Exhibit I-2
Distribution of Life-Health Insurer Reserves: 1950-2000

	1950	1960	1970	1980	1990	1995	2000
Reserves ($millions)	54,946	98,473	167,779	390,339	1,196,967	1,812,325	2,711,420
% Life	n/a	71.9	68.8	50.7	29.1	28.2	27.4
% Annuities	n/a	27.2	29.1	46.5	68.1	68.3	69.1
% Health	n/a	0.9	2.1	2.8	2.8	3.5	3.5

Source: American Council of Life Insurers

EXHIBIT I-3


Market Conduct Regulation
Standards
Surveillance/ Enforcement
Laws
Regulations
Other
Insurer Self-Compliance
In-Dept. Monitoring
On-Site Exams
Remedies/ Sanctions

REFERENCES