EXECUTIVE SUMMARY

PricewaterhouseCoopers LLP (PwC) is pleased to present the Insurance Market Conduct Examination Public Policy Review (Public Policy Review) to the Insurance Legislators Foundation (Foundation). The Foundation issued a Request for Proposal during 1998 for a Public Policy Review, which would review and analyze the market conduct examination activities of the insurance regulatory authorities of the 50 states. The objective of the Public Policy Review is 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.

PwC's Insurance Regulatory Solutions Practice (IRSP) and PwC's Survey Research Center (SRC) conducted the Public Policy Review. In addition, the Center for Risk Management and Insurance Research at Georgia State University served as an advisor and a substantial contributor to Public Policy Review. The following briefly summarizes the contents of this report.

RATIONALE AND HISTORY OF MARKET CONDUCT SURVEILLANCE

We commence with an overview of the rationale and the historical evolution of insurance market conduct surveillance. This review begins in the early 1970s when the National Association of Insurance Commissioners (NAIC) commissioned McKinsey & Company to study financial and market conduct surveillance of insurance companies. Limited information is available related to state market conduct examination practices prior to the 1970s. While it appears that insurance departments were performing some market conduct regulatory functions before 1970, it appears that the scope was limited and usually conducted as part of the financial examinations. Other market conduct surveillance activities were primarily "rate examinations", which meant that the examiners verified that the rates actually charged by insurers were the same rates filed with and approved by regulators.

During the 1970's, the NAIC worked with an industry advisory committee to develop the first market conduct examiners handbook (Handbook). This Handbook has been revised several times over the years. In addition, a professional certification program for market conduct examiners was developed. Information technology tools were also developed to support market conduct surveillance activities. Special problems, such as the abuses in the marketing of life insurance and annuity products, have also influenced regulatory thinking about market conduct examinations.

METHODOLOGY

We believed that the best way for the Foundation to obtain the information and insights that it was seeking was through a series of surveys of the two primary stakeholders, state insurance departments and insurers. Using a series of surveys, we conducted the Public Policy Review in the following Four Phases:

- Phase I - The goal of this initial phase was to contact each insurance department and determine which had separate market conduct units. For each department with a separate unit, we requested certain organizational and background information.
- Phase II - The goal of this phase was to understand the way in which market conduct examinations are administered by the insurance departments. We attempted to conduct in-depth-interviews with market conduct chief examiners identified in Phase I, from each of the 34 department with separate units.

- Phase III - In order to explore what happens in the field, we attempted to conduct in-depth-interviews with market conduct examiners-in-charge from each of the 28 insurance departments that participated in Phase II.
- Phase IV - In order to understand the market conduct examination process from an insurer's perspective, we contacted insurers that have undergone a market conduct examination in the last three years.

A brief summary of the participation in the above phases follows:

Initial	48 insurance departments
Chief Examiners	28 insurance departments
Examiners in charge	13 insurance departments
Insurance Companies	85 examinations which represents 78 insurers

The survey instruments utilized are contained in the appendix of this report.

Before any of the data collection efforts began, the project was introduced to the states, the district, and territories by NCOIL as well as by PwC. The three primary communications were:

- An announcement of the project and its purposes occurred during the February 1999 NCOIL Spring Meeting and Seminar in Savannah.
- A letter dated May 10, 1999 from NCOIL President David Counts was sent to all 55 state, district, and territory Directors of Insurance. The letter explained the purpose of the review and introduced James Schacht of PwC, the project leader, and Dr. Robert Klein of Georgia State University, the project advisor and contibutor.
- A letter dated June 29, 1999 from PwC was mailed to the Chief Examiners of the 55 state, district, and territory offices. The letter briefly explained the purpose of the study and referred to the May 10th letter.

SURVEY FINDINGS

Next we present the findings of the four survey instruments in a variety of areas which we thought were of interest. Rather than attempting to summarize the survey findings here, we direct the reader to that section of the report. The appendix contains the complete survey instruments.

SUMMARY OF OBSERVATIONS

We summarize our observation of the Survey Findings Section in this section. Rather than attempting to summarize our observations here, we direct the reader to that section of the report.

If time constraints do not allow the reader to review the entire report, we suggest that the reader review this section.

NEXT STEPS

As this study proceeded we identified a number of issues that went beyond the scope of this project. Therefore, we offer to the Foundation several ideas for additional research analysis related to market conduct surveillance. These next steps range from further manipulating the data obtained from the surveys to developing measures to determine the effectiveness of the market conduct examination process.

I. INTRODUCTION

PricewaterhouseCoopers LLP (PwC) is pleased to present the Insurance Market Conduct Examination Public Policy Review (Public Policy Review) to the Insurance Legislators Foundation (Foundation). PwC's Insurance Regulatory Solutions Practice (IRSP) and PwC's Survey Research Center (SRC) conducted the Public Policy Review. In addition, the Center for Risk Management and Insurance Research at Georgia State University served as an advisor and a substantial contributor to PwC.

A. PROJECT BACKGROUND

The Foundation is a non-stock, non-profit corporation formed in 1993. One of the purposes of the Foundation is to provide 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.

The Foundation issued a Request for Proposal during 1998 for a Public Policy Review, which would review and analyze the market conduct examination activities of the U.S. insurance regulatory authorities. The purpose of the Public Policy Review is 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.

The idea of conducting market conduct examinations separate and apart from the financial examinations resulted from a comprehensive study of the surveillance system of the U.S. insurance industry completed by McKinsey & Co. in the early 1970's completed on behalf of the National Association of Insurance Commissioners (NAIC). Because a review of marketplace practices was so unique, this study concluded that different examination personnel should perform distinct procedures as part of a market conduct examination. Since the time of this study, the individual state insurance departments have implemented that general recommendation in a variety of ways. While the National Association of Insurance Commissioners (NAIC) has sought to bring uniformity and coordination to market conduct examinations, no one has evaluated their success. The efficiency and effectiveness of market conduct regulation has not been evaluated to date. We are not aware of any comprehensive review of the market conduct surveillance system since the McKinsey & Co. study.

We believed that the best way to obtain the information and insights sought by the Foundation was through a series of surveys of the two primary stakeholders of market conduct regulation, state insurance departments and insurance companies. We believed the Foundation would be most interested in the insight and information from those state insurance departments that perform separate market conduct examinations of insurers. Using a series of surveys, we conducted the Public Policy Review in the following Four Phases:

- Phase I - The goal of this initial phase was to contact each insurance department and determine which had separate market conduct units. For each department with a separate unit, we requested certain organizational and background information. We also requested a list of the insurers examined in the last three years
- Phase II - The goal of this phase was to understand the way in which market conduct examinations are administered by the insurance departments. We attempted to conduct in-depth-interviews with market conduct chief examiners identified in Phase I, from each of the 34 department with separate units.

- Phase III - In order to explore what happens in the field, we attempted to conduct in-depth-interviews with market conduct examiners-in-charge from each of the 28 insurance departments that participated in Phase II.
- Phase IV - In order to understand the market conduct examination process from an insurer's perspective, we contacted insurers that have undergone a market conduct examination in the last three years.

A brief overview of the state insurance departments' participation is presented below. A detailed description, including an enumeration of the participation level of each jurisdiction, is provided in Section VII. Survey Methodology.

		NUMBER OF JURISDICTIONS
Survey I	**Initial Survey**	**55 jurisdictions**
	Number Responding	48
	No Responses:	
	• Omitted [1]	3
	• Other [2]	4
Survey II	**Chief Examiner Interviews [3]**	**32 with separate market conduct unit**
	Number interviewed	28
	Number not interviewed:	
	• Refused	2
	• Other [4]	2
Survey III	**Examiner-in Charge Interviews**	**32 with separate market conduct unit**
	Number interviewed	13
	Number not interviewed:	
	• Refused	3
	• Unable to schedule	5
	• No staff to interview	11

[1] U.S. Territories

[2] No response after multiple calls

[3] Interviews of Chief Market Conduct Examiners occurred only for jurisdictions which have a separate market conduct examination unit

[4] Scheduling difficulties

B. PROJECT DEFINITION

The objective of the Public Policy Review was to gain insight into the market conduct examinations by assessing the perceptions of different audiences. The following general areas of the market conduct examination process were addressed in the survey instruments:

- The definition of a market conduct examination
- The statutory basis of a market conduct examination
- The use of "contract" examiners in lieu of, or in additon to the state insurance department's staff examiners
- The statutory or other authority for using contract examiners
- How contract examiners are paid and the implications to state insurance department's budget
- The number and length of market conduct examinations "performed" annually
- The type of market conduct examinations (routine vs targeted) performed
- The reason(s) for iniating a market conduct examination
- The nature and depth of the training of the market conduct examiners
- The professional standards achieved by the market conduct examiners
- The role of the National Association's of Insurance Commissioners' Market Conduct Handbook (Handbook) in performing market conduct examinations
- The degree to which confidentiality is extended to the examination reports and workpapers
- The degree to which confidentiality is extended to the any self-critical analysis performed by insurance companies
- The extent to which an insurance company's self-critical analyses impacts the nature, scope amd timoing of market conduct examinations
- The scope of market conduct examinations
- The ability to expand the scope of an ongoing market conduct examination
- Procedures related to challenging possible inaccurate interpretations or applications of the law by examiners
- The extent to which examiners share information with other examiners and regulators
- Procedures related to reporting inappropriate examiner behavior during an examination
- Criteria for determining whether an insurer responded to examiner inquiries on a timely basis
- The extent to which remedial or corrective measures implemented during or subsequent to an examination impacts the market conduct examination report
- The extent to which an insurer's operations are disrupted during an examination
- Use of notice prior to initiating an on-site examination
- Content of the notice and the amount of lead time for insurers to get ready for an examination
- Procedures for addressing and/or correcting errors in examination reports before the reports are finalized
- The role of an insurer's response to an examination report
- The effect of enforcement activities

II. RATIONALE AND HISTORY OF MARKET CONDUCT SURVEILLANCE

It is useful to review the rationale for and the historical evolution of insurance market conduct surveillance to evaluate current practices. Our historical review begins in the early 1970s when the NAIC undertook its first investigation of market conduct surveillance and developed the first handbook for examinations. Little information is available on state market conduct practices prior to the 1970s. It appears that the states were performing some market conduct regulatory functions before 1970, but the evidence suggests that these functions were of limited scope. These activities were largely confined to "rate examinations", which verified that the rates actually charged by insurers were consistent with the rates filed and approved by regulators.

In 1971, the NAIC commissioned McKinsey & Company to study financial and market conduct surveillance of insurance companies. McKinsey's findings in 1974 led to the development of enhanced NAIC and state systems in both areas. At that time, the NAIC worked with an advisory committee to develop the first market conduct examiners handbook. Since then, the handbook has been revised several times as the states have enhanced the scope and sophistication of their market conduct functions. This evolution has included the development of a professional certification program for examiners and information technology to support market conduct regulation. The emergence of special problems, such as problems in the marketing of life insurance and annuity products, also has influenced regulatory thinking about market conduct. Reviewing these key developments helps us understand the current system for market conduct regulation. Our discussion starts with defining some terms and considering the economic rationale for market conduct regulation, followed by a review of its historical development.

A. DEFINITION OF TERMS

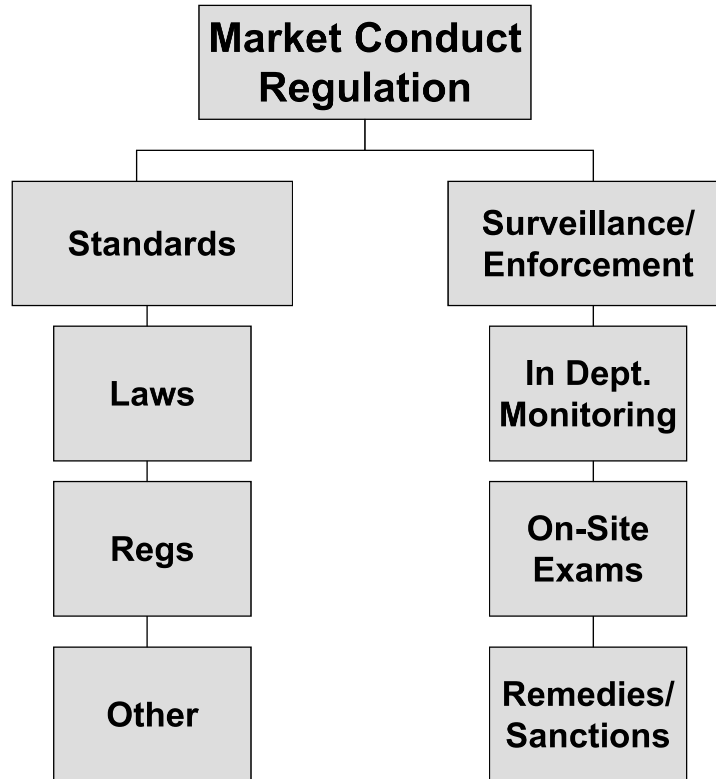
The terms "market conduct regulation", "market conduct surveillance" and "market conduct examinations" are used throughout this report. It is helpful to define what we mean by these terms and what we think most regulators believe them to be. In essence, these terms represent increasingly specific aspects of regulators' policing of insurers' and agents' market practices. Exhibit 2-1 presents a schematic diagram of the structure of market conduct regulatory 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.[1] 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
- Underwriting and pricing
- Issuance of insurance policies

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

Exhibit 2-1: Market Conduct Regulatory System



- 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. Regulators are most concerned about industry practices or actions that have adverse and unfair effects on consumers, policyholders and claimants/beneficiaries. Note, there is a distinction between practices or action 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 view negatively and/or in violation of state laws and regulations would 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 consumer
- 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 regulations
- 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, 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 are the primary focus of this report, they must be evaluated in the context of market conduct regulation, surveillance and enforcement actions, which influence or result from examinations.

We might further differentiate routine or periodic, comprehensive market conduct examinations from targeted examinations. Like routine financial examinations, routine market conduct examinations occur on a pre-arranged schedule (e.g., every three or five years) and are typically used to detect violations and problems and well as investigate specific practices. Targeted examinations, on the other hand, are triggered by some indication of potential market conduct violations or problems and are most likely to be confined to certain areas of concern or question.

B. Economic Rationale for Market Conduct Regulation

There is not a commonly articulated rationale for insurance regulation to which regulators and others tend to adhere. Historically, regulators have expressed different opinions on why insurance should be regulated and what regulatory objectives should be. Yet, it is possible to apply general economic theories of regulation to understand and evaluate insurance regulatory policies. This exercise offers conceptual support for some of the functions that insurance regulators perform, including market conduct regulation, as well as a basis on which to assess the need for and effectiveness of specific regulatory activities. This section suggests certain principles by which market conduct regulatory policies might be analyzed and evaluated. These principles guided the design of our surveys and the areas we have identified for further investigation.

GENERAL PRINCIPLES FOR REGULATION

The economic foundation for regulation is based on the concept of market failure. Market failures constitute violations of the conditions of workable competition, such as entry and exit barriers, excessive market concentration, and lack of information.[2] Market problems (i.e., excessive prices, unavailability of coverage, insolvencies, etc.) can be a consequence of a market failure or other factors that affect a market that is structurally competitive. In other words, not all conditions perceived as market problems are necessarily caused by a market failure. For example, high insurance prices may be the natural result of an increasing risk of loss driven by external factors and not the malfunctioning of the market per se. It is important to determine the underlying cause of market problems to determine the appropriate regulatory response.

Regulation is primarily intended to remedy 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 then is to correct market failures, or at least minimize their negative effects, and improve market efficiency. The principal market imperfections that regulation is intended to address are: 1) barriers to entry and exit; 2) externalities, where transactions create costs for third parties; and 3) internalities, i.e., costs and benefits of transactions that are not reflected in the terms of exchange (Spulber, 1989).

Effective regulatory intervention requires that regulators have good information and can determine and implement the correct market solution. To correct or counteract market failures, regulators may impose controls on entry, exit, prices, product quality, inputs to production, refusal to serve, and other private activities. 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 more efficient than others. Hence, it is reasonable to assert three conditions necessary for regulation to serve the public interest (Skipper and Klein, 1999).

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

Based on these general principles of regulation, we can suggest specific principles for insurance market conduct regulation.

SPECIFIC PRINCIPLES FOR INSURANCE MARKET CONDUCT REGULATION

Our discussion begins with the first two principles, which pertain to the activities that are regulated. This is followed by a discussion of the third principle, i.e., how such activities might be most efficiently regulated. These principles are pertinent to our review of market conduct examinations. Some issues may arise from questions about the need for regulation of certain practices, rather than from how they are regulated and examined. Other issues may arise not from questions about the need for regulation of certain practices, but rather from how these practices are examined and regulated.

Insurance regulation is principally targeted towards correcting market failures that would otherwise cause insurers' to incur an excessive risk of insolvency and/or engage in market abuses. The public interest

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

argument for the regulation of insurer solvency and market practices derives from inefficiencies created by costly information and principal-agent problems (Munch and Smallwood, 1981; Klein, 1995).[3]

The rationale that some offer for government restrictions on insurance prices is that consumer search costs impede competition and can lead to excessive prices and profits (Joskow, 1973; Harrington, 1992).[4] Further, imperfect information, constraints on consumer choice, principal-agent conflicts and unequal bargaining power between insurers and consumers could make consumers subject to abusive trade practices. Abusive practices might be broadly defined as practices that take "unfair" advantage of a consumer with material harm to the consumer. Additionally, the public may express a preference for regulatory policies to guarantee certain market outcomes consistent with social norms or objectives.[5]

Insurance economists generally believe that most insurance markets are structurally competitive (entry and exit barriers are relatively low) and do not require strict price regulation (Klein, 1999). However, they do not reject the possibility that some consumers may be vulnerable to unfair market practices and that market conduct regulation may offer some beneficial consumer protections. The need for and benefits of market conduct regulation derive primarily from imperfect information. 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.

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. Insurance regulators accomplish this objective through several means. First, regulators typically approve the insurance products that are sold to individuals and some businesses. Regulators may disapprove products that they believe are unsuitable, offer inadequate coverage, or contain other provisions in conflict with state laws. Second, regulators attempt to ensure that only approved insurance products are sold. Third, regulators may impose certain standards with respect to disclosure and representations, other sales and marketing practices (e.g., suitability, replacement, etc.), and the "readability" of contracts. Fourth, insurance departments seek to educate and inform consumers about purchasing insurance.

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[3] Costly information refers to the fact that it is costly for consumers to acquire information about the financial condition of an insurer and the relative value of its products in relation to their prices. Principal-agent problems refer to the difficulty that a consumer (the principal) faces in monitoring and controlling the activities and financial risk of an insurer (the agent), once the consumer has signed a contract with the insurer and paid premiums for coverage of future claims and benefit obligations by the insurer.

[4] Insurance rate regulation is rooted in an earlier period when insurer pricing was "cartelized" through industry rating bureaus, which required regulatory oversight. This paradigm was reaffirmed after the enactment of the McCarran-Ferguson Act in 1945. Since then, however, the role of rating/advisory organizations has changed significantly and insurer pricing has become very independent and competitive.

[5] For example, most states have determined that drivers should carry some form of liability or no-fault auto insurance. Because of this requirement, some policymakers believe that the government should ensure that insurance coverage is reasonably available and affordable for those who are required to purchase it. This argument has been used to justify strict controls on auto insurance rate increases in some states.

These are the primary regulatory measures that are intended to prevent consumers from engaging in harmful transactions because of lack of information. The states also regulate insurers' underwriting and risk classification practices to varying degrees. Regulations governing policy terminations also might be included in this category. This regulation derives not from imperfect information per se, but rather might be justified on the basis of constraints on consumer choice and unequal bargaining power between consumers and insurers. At a minimum, the states prohibit insurance underwriting and pricing based on certain criteria that are considered socially unacceptable and unfair, such as race or religion. Some states go beyond this and prohibit other risk criteria such as sex, marital status, geographic location, etc., depending on the type of insurance. The regulatory concern is that insurer use of certain criteria would unfairly limit the supply or availability of insurance to some individuals, particularly if all insurers use the criteria. Public norms or preferences may influence regulation of risk classification and underwriting at the expense of economic efficiency and "actuarial fairness".

Such prohibitions must be monitored and enforced through market conduct regulatory activities. The public policy issue is not the enforcement activity per se, but rather the regulatory prohibitions that require enforcement.[6] This is gray area from an economic perspective, as there are often different views on whether a certain underwriting criterion is "actuarially justified" and whether actuarial justification is sufficient to permit a criterion to be used. In this report, we accept regulations governing underwriting as a matter of fact, and focus our attention on the question of how such regulations are enforced.

Finally, we come to the regulation of insurers' claims handling practices. Arguably, all of the insurance market failures listed above could lead to problems in this area that would benefit from some regulatory intervention. Poorly informed consumers may be more vulnerable to insurers' failure to meet their contract obligations because the consumers do not fully understand what those obligations are. Because of the contingent nature of insurance contracts, switching to another insurer is not an option for a policyholder after he or she has suffered a loss. Also, individual consumers may be pressured to accept inadequate claims payments because they do not have sufficient resources to sustain a lawsuit against their insurer.

The states seek to regulate insurer conduct in claims handling through laws and regulations, standards or requirements for claims handling; administration of consumer complaints; and market conduct surveillance and enforcement actions. Since regulation of claims handling often involves interpretation of insurers' obligations under their contracts, the regulatory discretion exercised in market conduct regulation becomes very important. Hence, in this area, insurers may readily accept some regulatory findings and sanctions and dispute others. Similarly, economic analysis may support the need for some regulatory activities and actions governing claims handling, but not others. Regulators can address clear violations of insurance laws, but are not in the best position to resolve claim disputes involving questions of law and fact that require judicial determinations.

We now come to the question of how the insurance trade practices discussed above might be most efficiently regulated. We use efficiency principles to identify surveillance approaches and techniques that may warrant review and reforms that might be considered.

One reasonable efficiency principle is that on-site market conduct examinations should be used for what they are best suited and less costly methods should be used when they can do the job. Hence, the first set of issues concern the role of market conduct examinations within the overall surveillance framework and the use of routine and comprehensive versus targeted examinations. Are on-site examinations efficiently

[6] Of course, the interpretation of what is prohibited or unfair may be partially exercised through market conduct examinations.

coordinated with other detection measures, such as complaints, desk exams, testing and other methods of gathering information? Are on-site examinations used to obtain information that cannot be gathered at a lower cost through other means? Do examination triggers prompt examinations when warranted and prevent unnecessary examinations? Are routine, comprehensive examinations necessary to detect some market conduct violations, or could targeted examinations alone achieve regulatory objectives?

Another efficiency principle is that examinations should focus on areas where they can most effectively find violations and problems, using cost-effective detection techniques, and avoid areas where violations and problems are very unlikely, difficult to detect or not material. This principle leads to a second set of issues concerning the scope and methodology of market conduct examinations. Is the scope of some exams too broad, resulting in excessive costs for both regulators and insurers? Conversely, are there important areas that some exams skip over that could and should be reviewed? Should exams seek to find all errors, even if minor or inadvertent, or should they focus on patterns of practice that constitute significant and systematic abuses? Also, do examinations make effective use of information technology to expedite the process and lower costs? To what extent are insurer files sampled as opposed to a census of all files and how do these methods affect exam effectiveness and cost?

There are other questions about the time that examinations take and the process for issuing examination reports. Do examinations take too long or is their length warranted given the amount of information that must be reviewed? Do examiners and insurers work cooperatively and coordinate their activities to avoid unnecessary delays or costs? Are information flows between regulators and insurers adequate? Are examination reports finalized and published as quickly as possible? Does the need to resolve disputes about examination findings necessarily lengthen the time frame between completion of exams and the issuance of reports? Is the process for considering insurer responses to examination findings fair and efficient? Is the public dissemination of examination findings reasonable and does it document insurer responses?

A third principle is that the personnel performing examinations should be capable. This raises a fourth set of issues involving the qualifications and training of examiners. Do examiners have sufficient expertise to review and evaluate insurers' market conduct and do so in an efficient way? Are training programs and certification requirements adequate? What are the advantages and disadvantages of using contract versus staff examiners? Is the mix of contract and staff examiners cost effective?

Finally, we come to questions concerning regulatory sanctions and the implications of insurer self-monitoring and correction of market conduct errors and problems. These issues arise from the principle that enforcement actions should encourage compliance with regulations and result in remedies that serve consumer and public interests. Are financial penalties and regulatory remedies fair and appropriate? Do they provide insurers with proper incentives to avoid market conduct violations and correct problems that they find?

The issues listed above are not exhaustive, but they represent many of the important questions about the efficiency of market conduct regulation, surveillance and examinations. Below we review how market conduct surveillance has evolved historically as reflected in NAIC recommendations and materials. In our historical review, we focus on key developments and the important issues that have been debated as the market conduct surveillance system has evolved. The reasons why certain decisions were made are as important as the decisions themselves.

C. THE MCKINSEY STUDY

In 1971, the NAIC engaged McKinsey & Company, Inc. to evaluate and make recommendations concerning both insurance financial and market conduct surveillance systems. Working closely with

NAIC committees and task forces, as well as advisory committees, McKinsey developed and implemented a rigorous study plan. The study included extensive interviews of regulators, insurers and other experts to solicit their views and suggestions on financial and market conduct surveillance. McKinsey also surveyed state practices at that time.

Through 1972 and 1973, McKinsey submitted several preliminary reports and solicited feedback in refining their analysis and findings. In April 1974, McKinsey submitted a final report that guided subsequent NAIC and state activities in implementing the report's recommendations. The NAIC established a Market Conduct Surveillance Handbook Task Force, which with the assistance of an advisory committee, developed the first market conduct examination handbook in 1975.

RECOGNITION OF THE IMPORTANCE OF MARKET CONDUCT SURVEILLANCE

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 insurers' 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 state market conduct activities expanded, these activities would be conducted in an effective, efficient and consistent manner.

The McKinsey report is somewhat remarkable in its farsighted and progressive ideas. Almost thirty years later, some of these ideas continue to be endorsed, yet still have not been fully realized. This will become apparent as we compare the evolution of actual regulatory market conduct practices with the vision presented in the McKinsey report and related NAIC documents.

PHILOSOPHY, PURPOSE AND SCOPE OF MARKET CONDUCT SURVEILLANCE

Section 4 of the final McKinsey report (1974) focuses on market conduct surveillance. The report states that the purpose of market conduct surveillance is to "protect policyholders and claimants against unfair market practices." It observed that, although some states had been dealing with selected market conduct problems for many years, few had developed comprehensive, organized systems for this purpose. State market conduct activities consisted primarily of "rate examinations" which verified that insurers' were charging the rates that had been approved by regulators and the premium calculations were correct.

McKinsey addressed the following five areas in its analysis:

- Identification of market conduct problems
- Approach to market conduct surveillance
- Need for market conduct specialists
- Key elements of the market conduct surveillance system
- Approach for ensuring interstate cooperation

Market conduct problems were found to occur most frequently in the areas of: 1) sales and advertising; 2) underwriting; 3) rating; and 4) claims handling. Sales and advertising problems were generally characterized by misrepresenting policy provisions and future dividends and encouraging inappropriate replacement of policies. Underwriting abuses constituted unfair discrimination in risk selection and the failure to provide adequate notification of policy terminations and premium refunds. Rating issues comprised violation of regulatory rate standards (adequacy, non-excessiveness, and fairness) and charging rates different from those filed and approved. Unfair claims practices included misrepresenting claimants' rights, underwriting at the time of the claim, failing to answer correspondence, forcing legitimate claims

to litigation, and pressuring claimants to accept unreasonably low settlements. McKinsey noted that the nature and frequency of market conduct problems cross many different areas of company operations and may vary considerably by line, marketing approach and geographic region. At the same time, it is interesting to note that the basic types of market conduct problems encountered in the early 1970s appear to be similar to the types of problems that consumers and regulators encounter today.

The McKinsey report espoused a philosophy in approaching market conduct surveillance that is still reflected somewhat in the current market conduct examiners 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 treat policyholders unfairly. In other words, regulators should focus on a pattern of unfair practices or actions, rather than inadvertent and occasional mistakes. Such patterns are to be identified either 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.

McKinsey further advised that market conduct specialists should be used to market conduct surveillance. These specialists should understand applicable laws and regulations, know how to interpret them, possess expertise in the areas they are examining, and have sufficient time to fulfill their responsibilities. Implicit in this recommendation is the notion that certain regulatory personnel should be dedicated to market conduct surveillance, rather than delegating this responsibility among staff members who lack the necessary expertise and specialization. This remains an interesting question today, as some insurance departments do not have separate market conduct units or personnel.

ELEMENTS OF AN EFFECTIVE SYSTEM

The report identified three key elements of an effective and efficient market conduct surveillance system:

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

One interesting observation is 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. The explanation may be that many regulators believe that routine examinations are necessary because other detection methods are insufficient by themselves to identify all significant market conduct problems. This issue is discussed further below.

McKinsey advised heavy (although not exclusive) reliance on a complaint analysis system to target problems and initiate examinations. McKinsey viewed complaint analysis in the area of market conduct surveillance as the counterpart of financial analysis in the area of financial surveillance.[7] According to McKinsey, a complaint system should be capable of pinpointing:

- Companies with a high number of complaints in relation to their size

[7] Other types of information that have become available and the potential development of a "market conduct statement" now offer additional data sources to conduct market conduct analysis within insurance departments.

- Specific lines of business with a high incidence of complaints
- The most frequent causes of complaints.

McKinsey noted that few states had such complaint systems at that time and recommended that the states develop uniform complaint systems coordinated by the NAIC. Many states, although not necessarily all, have since developed such systems and participate in the NAIC complaint system.

McKinsey further recommended that the results of each market conduct exam be documented in a timely, action-oriented report. We will see below that the timeliness and content of exam reports are among the principal concerns about the current system.

Interstate Cooperation

The need for interstate cooperation was acknowledged early on. While McKinsey believed that each state could most effectively exercise surveillance over its own market, it also recognized that company operations and market conduct frequently extended across states. Indeed, this is even more the case today than it was in the early 1970s. Two critical areas for cooperation were identified:

- Sharing information that is relevant to market conduct activities in other states
- Coordinating field examinations of company offices that serve more than one state

Here again, the extent of interstate cooperation, communication and coordination (or the lack of it) remains a significant issue today.

With respect to information exchange, McKinsey noted that sharing of findings that an insurer was not engaging in unfair practices was as important as sharing adverse findings. The NAIC was seen as the logical clearinghouse for such information.

With respect to exam coordination, McKinsey anticipated that one state could perform examinations for other states, or individual state examinations could be conducted concurrently. It observed that the feasibility of coordination needs to be evaluated on case-by-case basis and is probably most practical for examinations of the same type or area. McKinsey further recommended that a state notify other states when it schedules an examination and that a company's domiciliary state should identify exams that might be coordinated. The examination tracking system since developed by the NAIC provides a vehicle for notifying other states of exams.

Impact of the McKinsey Study

It is clear that the McKinsey study played a major role in forming early NAIC opinions, documents and systems with respect to market conduct surveillance. One of the products of the study was the first draft of an NAIC Market Conduct Surveillance Handbook, which embodied many of McKinsey's recommendations. Current NAIC market conduct materials and systems are rooted in the McKinsey report and the activities that immediately followed. Below we discuss the NAIC's market conduct activities following its receipt of the McKinsey report.

D. The First Market Conduct Surveillance Handbook

NAIC ACTIVITIES

Concurrent with McKinsey's study activities, the NAIC established the Market Conduct Surveillance Handbook Task Force to provide input to the study and oversee development of the handbook as one the study's major products.[8] Using the McKinsey work product, the Task Force issued a report and a draft model Market Conduct Surveillance Handbook. The Examination (A6) Subcommittee adopted the report and handbook in December 1974. The NAIC circulated the draft handbook to the states in a pilot test program in January 1975. The Task Force appointed an Industry Advisory Committee (AC) to provide technical assistance in refining the handbook for adoption at the NAIC's December 1975 meeting.[9] During this period, the Missouri Insurance Department also issued a report describing its approach to market conduct surveillance and offering recommendations for other states.

The AC submitted a report and revised draft handbook to the Task Force in December 1975. The AC report reflects some of the issues and different opinions on how market conduct surveillance should be performed. In large part, it praised and incorporated the initial draft handbook, but the AC also presented several criticisms and suggestions for changes. We pass over criticisms that appear to be a matter of semantics and focus on those that were more substantive.[10]

ADVISORY COMMITTEE VIEWS

The AC stressed the need for a "statement of philosophy" in the introduction of the handbook to help guide examiners. Interestingly, contrary to McKinsey, the AC recommended routine examinations to avoid the presumption of unlawful activity that would be generated by targeted examinations.[11] It urged the need for cost efficiency, recognizing that any examination costs assessed to insurers would be passed to consumers. The AC recommended against the imposition of 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 AC stressed the need for due process and that regulators should respect insurers' legal rights in the market conduct surveillance process.

On the question of how the examination system should be financed, the AC strongly recommended that all system costs be funded from general state revenues. It argued that state funding was preferred to assure the public that companies would not have undue influence, to assure insurance departments of a stable and pre-determined source of funding, and to ensure that funding is "not open-ended and controlled only by the aggressiveness of the department." Of course, the issue of how exams should be financed remains today, motivated primarily by insurer concerns that company funding reduces regulators' incentives to control costs.

[8] The Task Force reported to the NAIC Examinations (A6) Subcommittee.

[9] Consistent with the practice at that time, the advisory group was referred to as the Industry Advisory Committee. The group's members consisted of representatives from insurance companies and trade associations, as well as academics.

[10] Semantics can be important to some people because of the messages that they believe are communicated by certain words. For example, the AC preferred the use of the word "unlawful" practices rather than "unfair" practices because it believed that use of the latter term would prompt regulators to make subjective judgments about company activities that were a matter of insurer discretion.

[11] Insurer preferences with respect to routine versus targeted examinations may have since changed.

The AC also agreed with the view that state market conduct surveillance activities and exams should be coordinated to the maximum extent possible. It affirmed reliance on zone examinations, when feasible, and that duplicate or repetitive exams should be avoided when an initial exam either validates a company's practices or requires corrective actions that are implemented in all of its geographic areas of operation. The AC made several additional recommendations:

- Both financial and market conduct exams should be under the same regulatory staff member, e.g., the "Chief Examiner";
- Notifications of exams should be sent to all states;
- Insurance commissioners should have the authority to waive exams when appropriate;
- Financial exams and market conduct exams should be coordinated and conducted at the same time whenever possible; and
- Published exam reports should include the comments of the company on disputed conclusions.

We see here that the AC preferred less of a separation between financial and market conduct regulatory activities than that recommended by McKinsey.

It also is apparent that the AC was concerned about the subjective nature of some of the areas and practices that regulators might examine and the perceptions created by the instigation of an examination. As noted above, the AC argued for routine, rather than triggered market conduct examinations. It believed that considerable experience was required before exam triggers could be developed. The AC 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 AC 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.

State Activities and Reports

It appears that several states took an early lead in developing significant market conduct regulatory functions, including California, Illinois, Massachusetts, Missouri and New York. We have not found published sources that detail the market conduct activities of the various states during the 1970s (or the 1980s, for that matter), but the Illinois and the Missouri insurance departments issued reports that provide some glimpses of their views on and systems for market conduct surveillance. It is reasonable to surmise that the initiatives of particular states influenced NAIC recommendations and the systems developed by other states.

The report presented by the Missouri insurance department in 1975 is important because it reflects the views of a leading state on how regulators should approach market conduct surveillance (Missouri Department of Insurance, 1975). Missouri's market conduct regulation was highly developed compared to other states at the time. Missouri established a separate market conduct surveillance unit in the early 1970s. Missouri argued for an active and pro-active market conduct function with a considerable resource commitment, separate from financial regulation and examination functions. Other recommendations in its report included:

- Continuing training and education of examiners
- Cooperation among all divisions within the insurance department
- Examination planning, including pre-exam complaint reports
- Use of statistical data and methods in conducting exams
- Inter-state cooperation and coordination
- Pre-admission market conduct exams
- Competition monitoring.

The Missouri report also offered a number of sample reports, forms and other materials to illustrate its recommendations.

The Illinois report followed several years later in 1979 (Illinois Department of Insurance, 1979), a time when market conduct regulation was still in its formative stages. The report, authored by Kenneth W. Smith (Deputy Director), was written primarily for internal department purposes to recommend a strategy for and improvements in Illinois market conduct activities with respect to property-casualty markets. It detailed and critiqued all elements of its market conduct surveillance system. At the same time, the report was offered to other states for their consideration in developing their respective systems. It also provides some glimpse into regulatory thinking on market conduct issues as it evolved after the NAIC's initial activities.

The Illinois study of its system utilized the McKinsey report, the NAIC Market Conduct Examination Manual, and the examination handbooks of Illinois, Missouri and Massachusetts as references. The report strongly affirmed the philosophy that market conduct surveillance is an important and necessary regulatory function and that it should focus on general business practices rather than individual human errors. It also argued that market conduct exams should be performed by staff members with special market conduct expertise, rather than financial examiners.

Illinois introduced market conduct examinations in 1970 in conjunction with its move to competitive rating for property-casualty lines at the same time. Like other states, it initially focused on rate examinations and then increasingly focused on claims handling.[12] This was consistent with the premise of competitive rating that insurers' rates are not second-guessed by regulators, unless they find a lack of competition.[13] The report observed that claims handling required close regulatory review for some of the reasons articulated in our earlier discussion of regulatory principles. It also noted the need to review advertising, sales and underwriting practices.

The Illinois report further argued that it was appropriate for a state to perform market conduct examinations of the branch offices of both domestic and non-domestic companies. It expressed uncertainty as to how market conduct examinations could be conducted as a zone examination.

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[12] It was noted that Illinois modeled its rate examinations after California practices. The Illinois competitive rating law sunset in August 1971 and was not reenacted. Hence, market conduct exams were performed under the Illinois Director's general examination authority. Life, accident and health market conduct examinations were commenced in 1973.

[13] Obviously, states that retained prior approval rating systems, such as California, may have paid greater attention to rates in their surveillance activities.

The study did affirm several other recommendations in the McKinsey report and implied that the department's activities at that time were adequate in some of these areas. These areas included:

- Examination triggering and scheduling based on complaint data and other information
- Statistical sampling of insurer files and established procedures and related forms for reviewing company documents
- Developing organized exam work papers

Illinois criticized several aspects of its market conduct surveillance system at that time, including:

- Pre-exam preparation and communication were inadequate, which contributed to inefficiencies in examinations.
- Examination reports were too lengthy and their length contributed to unnecessary delays in their completion.
- The number of examiners had decreased and was insufficient to cover Illinois markets.
- The department needed to improve its management of examiners and the effective utilization of personnel.
- The department lacked organized training programs and materials.

THE ELEMENTS OF THE FIRST HANDBOOK

A detailed review of the content of the first Market Conduct Surveillance Handbook is beyond the scope of this report, but it is helpful to summarize its basic elements and important aspects that reflect its vision of market conduct regulation and examinations. Following the McKinsey report and associated NAIC deliberations, the first handbook set the foundation for the development of market conduct surveillance. At the same time, we must recognize that the handbook was and still is a "model" and that the actual practices of the various states have not always been consistent with the handbook.

The introduction to the handbook was intended to set the tone and a guiding philosophy for market conduct examinations. One theme was that market conduct surveillance should be focused on practices, lines and companies where problems were most likely to be found, rather than equally distributed across all segments of the industry.

The handbook included the following sections summarized below, reflecting what the NAIC viewed as important in performing market conduct surveillance.

- Market Conduct Statutes, Rules and Regulations
- Scheduling and Planning Market Conduct Examinations
- Examining for Unlawful Sales, Advertising, Underwriting, Rating and Claims Practices
- Conducting Examinations for Property-Casualty, Life and Health Insurers
- Reporting Examination Results
- Exchanging Information Among States

Much of the text of the handbook dealt with the kinds of practices that could be unlawful or unfair and how regulators might ascertain such practices. Sample forms and reports also were provided as examples.

Several aspects of the handbook deserve special mention. One aspect is the emphasis on unlawful practices, rather than practices that regulators might believe are inappropriate but are not in violation of state laws. A second aspect is the reliance on complaint analysis and other information to prioritize examinations and guide the scope of examinations. Other key themes include examination pre-planning, adherence to established schedules and timeframes, and interstate communication and coordination. There also was a stated preference for relying on examinations performed by other states to avoid duplicative or repetitive examinations.

In Chapter IV: Unfair Market Conduct Practices, we see the inclusion of the following statement that affirmed views in the McKinsey Report on the proper philosophy and orientation of market conduct surveillance.

> *Since it is inevitable that all companies will, on occasion, make errors that result in unfair treatment of policyholders, market conduct surveillance must be selective. It can only be effective if it focuses on general business practices as opposed to instances of treatment of policyholders or claimants, which may be infrequent or unintentional* [emphasis added].

The handbook goes on to state that a company is engaging in a general business practice if:

1. *The underlying cause of the problem, regardless of its frequency, can be traced to a company policy or regularly followed procedure as distinguished from an unintentional error.*

2. *The frequency of the problem – e.g., the percentage of auto policies incorrectly rated – is significantly greater for the company than the standard determined acceptable.*

E. Further Development of the Market Conduct Handbook

After its first adoption in 1975, the market conduct handbook went through several revisions, the most recent occurring in April 1999. Over this period, it was re-titled the Market Conduct Examiners Handbook, hereafter referred to as the "Handbook". Rather than review each of its iterations, we compare the current Handbook with the first handbook and note how it has been refined and expanded. The current Handbook reflects the experience that has been gained and the increased sophistication of market conduct surveillance methods. The current Handbook provides much more detail, includes more sample documents and covers additional areas. Its organization provides a guide for how a state might conduct examinations, with modifications for specific state circumstances.

Philosophy, Scope, and Uniformity

The introduction to the current Handbook reflects the evolution in regulatory thinking about market conduct surveillance, or at least the views that have shaped NAIC models. The Handbook reasserts the need for a separate and distinct market conduct surveillance function and this view appears to be stronger than that articulated by McKinsey and the Advisory Committee. The scope of market conduct surveillance and exams has been significantly extended. The areas of market conduct review have been expanded beyond the four areas in the first handbook to include: 1) company operations/management; 2) complaint handling; 3) marketing and sales; 4) producer licensing; 5) policyholder service; 6) underwriting; and 7) claims. We also see a restatement of the philosophy of market conduct exams.

> *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 examinations 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 appears to temper the relative emphasis on company practices versus inadvertent errors espoused in the McKinsey study and the first handbook.

Further, the Handbook recognizes that examination approaches vary among the states, guided primarily by "each jurisdiction's approach to marketplace involvement" and its resources. The Handbook urges states to standardize their market conduct standards and exam procedures to the extent possible, utilizing the Handbook as a guide, but also states that a particular jurisdiction may need to modify or supplement the handbook to meet its specific laws and needs.

EXAMINER QUALIFICATIONS

One of the valuable advances in market conduct regulation has been the development of a certification program for market conduct examiners. The Insurance Regulatory Examiners Society (IRES) is the professional organization that is utilized to establish examiner certification requirements and offer educational courses for examiners. IRES examiner certification requirements include IRES courses, experience, compliance with a code of professional conduct and ethics, and continuing education. IRES offers two designations: the Accredited Insurance Examiner (AIE) and the Certified Insurance Examiner (CIE). The Handbook lists six classifications or levels of examiners and the qualifications that must be met for each level. The qualifications are based on IRES education and certifications, experience, and job functions. The classifications of examiners are referenced in the Handbook's recommendations on the types of personnel that should be utilized in market conduct surveillance activities and examinations.

TYPES OF EXAMINATIONS

The Handbook identifies and describes six basic categories of examinations, comprising a complete market conduct regulatory program.

- Comprehensive or full-scope examinations, which may or may not be conducted on a routine basis
- Target examinations that are specific to one or more areas of concern and may be called at any time as circumstances dictate
- Re-examinations to follow-up on specific issues and determine insurer compliance with previous examination recommendations or administrative orders
- Multistate cooperative examinations when issues or practices cross state borders
- Desk examinations performed within the insurance department using information supplied by an insurer
- Specialized examinations for entities other than standard insurers

These categories of examinations represent the array of approaches available to regulators and the need for procedures for non-traditional insurance entities that are becoming increasingly significant in the insurance marketplace.

SCHEDULING, COORDINATION AND COMMUNICATING

The detailed procedures offered in this section of Handbook illustrate the significant advances in exam preparation and post-exam activities that are now available to regulators. While complaint analysis information still has a significant role, the Handbook identifies 14 sources of information for prioritizing examinations, including information available from several NAIC databases and computer applications. The NAIC automated Examination Tracking System (ETS) provides an efficient tool for sharing

information among states. The Handbook details procedures for calling and announcing an exam, using the ETS, to maximize interstate cooperation.

SAMPLING

The Handbook now contains a chapter on sampling as an important and efficient auditing tool. Sampling of files can be utilized to detect problems when the time and cost of reviewing all files is impractical. At the same time, the Handbook notes that the availability of computerized audit software tools may permit the review of the full universe of files.

CONDUCTING EXAMINATIONS

The current Handbook contains separate chapters for conducting exams of property-casualty, life, and health insurers. This reflects the different natures of these types of insurers, differences in the kinds of practices that are recommended for review, and the techniques recommended for each type of insurer. Additionally, the Handbook contains a chapter on multistate examinations and separate chapters on examinations of special entities, including: statistical agents, surplus lines brokers, premium finance companies, title insurers and agents, and third-party administrators.

In addition to providing an overview of recommended examination approaches for each of the areas for review identified above, these chapters provide a number of general standards that set the level of conduct that a company is expected to meet. The standards are presented in a specially formatted page for each standard (see example in Box 2.1) that includes the following:

- The particular standard
- The types or lines of insurance to which it applies
- The priority level
- Documents to be reviewed
- Review procedures and criteria

These standards help to guide examiners in a standardized way. However, a given state may believe it is necessary to modify the Handbook standards for their particular use. Also, some insurers may be concerned that the Handbook standards unnecessarily increase the stringency or scope of examinations in some states.[14]

THE EXAMINATION REPORT

As we will see below in the discussion of our survey findings, the timing and content of market conduct examination reports have been a continuing concern of insurers and some regulators. The Handbook contains a chapter on this topic that at least has the potential for promoting best practices in exam reporting. The chapter provides a detailed outline for the organization and content of the examination report. Two different types of reports are described: 1) report by exception; and 2) report by test. The chapter also advises states to notify an examined insurer of the state's policies and procedures for

[14] This is the "double-edged sword" aspect of NAIC models from the perspective of the industry. On the one hand, NAIC models encourage uniformity, which multistate insurers tend to support. On the other hand, there is the industry concern that NAIC models may unnecessarily "raise the bar" for some states in terms of the stringency and scope of their regulation.

reviewing, challenging, finalizing, and distributing the exam report. With respect to the distribution of exam findings, the Handbook states the following.

> *Any distribution of [a] filed report may include the examiner's report, the company's comments and objections, and any results of department comments and orders or stipulations.*

F. OTHER KEY DEVELOPMENTS

MARKET DEVELOPMENTS

As insurance markets have grown and evolved, new products and practices have emerged, and other products and practices modified, market conduct activities also have evolved. Industry changes have influenced the types of problems that regulators have sought to police and possibly the scope and procedures of market conduct examinations. Here we briefly summarize some of the more important market developments, which are discussed in more detail in the next chapter.

Property-liability insurers have become subject to greater competition and economic stress, which could have some implications for market practices. Cyclical pricing and cost and price escalation in certain personal and commercial lines can have short-term effects on the availability of coverage, underwriting, policy terminations and claims handling. Responding to price-conscious consumers, insurers have explored innovations in risk classification and policy provisions. Regulators may view some of these innovations as reasonable, but may have concerns about others (e.g., the use of credit history information in underwriting personal lines policies).

Accident and health insurers also have faced rising costs and fierce competition. Employers have pressured insurers to control costs through managed care programs. New entities, such as Preferred Provider Organizations (PPOs) and Health Maintenance Organizations (HMOs) have become important players and raised new market conduct issues, such as quality of care. Underwriting and pricing practices also have received increased attention as employers and other payers have sought to avoid cost shifting and subsidies of high-risk groups. Monitoring market conduct in managed care has emerged as one of the more challenging new tasks of regulators.

Finally, new and more complex life insurance, annuities and investment and retirement-related products have emerged to compete with the offerings of non-insurance financial institutions. The new insurance products are more difficult for consumers to understand and have led to problems in sales representations of expected versus guaranteed returns. Also, regulators have questioned whether some consumers have been induced to make unsuitable replacements of their existing policies.

NAIC MODEL LAWS AND REGULATIONS

The regulation of insurance markets and the focus of market conduct examinations are closely intertwined and the developments summarized above and others have prompted new laws and regulations. Hence, the development of NAIC model laws and regulations and their enactment and modification by the various states have had significant implications for insurance market regulation and market conduct surveillance. The NAIC's establishment of a Market Conduct (EX3) Subcommittee and Market Conduct (EX3) Task Force reflects the increased attention to market conduct regulation. Below is a partial list of NAIC models that are particularly relevant to unfair trade practices and market conduct.

- Unfair Trade Practices Act
- Unfair Claims Settlement Practices Act

- Unfair Property/Casualty Claims Settlement Practices Model Regulation
- Unfair Life, Accident and Health Claims Settlement Practices Model Regulation
- Improper Termination Practices Model Act

Other model laws and regulations deal with unfair discrimination against certain groups, record retention, and other practices dealing with specific issues such as the use of after market parts in auto repairs and disclosures in the sale of life insurance. As these laws and regulations address perceived problems and detail specific standards or legal requirements, market conduct examiners, in turn, must adjust their review to assess compliance with enhanced and articulated requirements. The evolution of insurance markets has prompted new and enhanced laws and regulations. Arguably, one significant development has been diminished regulation of prices and increased attention to policy provisions and market practices. Competition has helped to keep insurance prices low while new and more complex insurance products have been developed to serve consumer and business needs. The availability of some types of insurance has received increased attention because of compulsory insurance requirements and economic events that have reduced the supply of insurance at various times.

THE INSURANCE REGULATORY EXAMINERS SOCIETY AND EXAMINER EDUCATION

As noted above, the emergence of IRES in 1987 has promoted the training and professionalism of market conduct examiners. The Society of Financial Examiners (SOFE) had been serving as the professional organization for financial examiners. Market conduct examiners created their own organization to meet their particular needs. It is probably fair to say that, historically, market conduct regulators perceived that they did not receive the level of respect and support given to financial examiners. IRES has enhanced the recognition and role of market conduct regulators. Also, IRES has provided an additional forum for regulators to share information, discuss market conduct issues and raise public attention.

IRES membership is international and open to insurance regulatory professionals who work in the field, as well in insurance departments. It has more than 1,000 members. IRES provides several services, including:

- Meetings, seminars, workshops and schools
- Education and certification programs for examiners
- Professional code of ethics
- Newsletter
- Web site

An Accredited Insurance Examiner (AIE) must be extensively trained in either property-casualty or life-health insurance regulation and complete at least eight professional development courses in a selected curriculum. To seek accreditation as an AIE, a regulator must have completed at least two years of verifiable full-time regulatory work (this requirement will be increase to three years in August 2002). A Certified Insurance Examiner (CIE) is presented to an insurance regulatory professional who has attained the AIE in one field and then cross-trains in the other field by taking four additional courses. To retain these designations, examiners must satisfy continuing education requirements and continue their membership in IRES.

The NAIC also has significantly expanded its education programs since the late 1980s, which have supplemented the education and training activities of state insurance departments and IRES. The NAIC has a special on-site education program for market conduct regulators, as well as incorporated market

conduct sections into its general regulatory education programs. Enhancing all regulators' understanding of market conduct serves to support this function.

DATABASES AND COMPUTER APPLICATIONS

Another area where the NAIC has performed a valuable function is in the development of databases and computer applications that can be used by state regulators to enhance their efficiency and effectiveness. Some of these systems pertain to market conduct, others to financial analysis, and some support both areas. The development of these systems started in the 1970s and greatly accelerated in the late 1980s. Various platforms have been created to provide efficient access, including: on-line systems, client server platforms, and CD-Rom technology.

Among the systems that are directly related to market conduct are:

- The Regulatory Information Retrieval System (RIRS), which contains information on formal regulatory actions against insurers and agents.
- The Special Activities Database (SAD), which contains confidential references and contacts for entities that have received some regulatory attention, but not necessarily formal regulatory action.
- The Complaint Analysis System which provides a standardized format and database for insurance departments to report complaints received against insurers and agents.
- Computerized audit software.
- Computerized statistical reports to facilitate exam preparation.

Other general support systems that support market conduct as well as other regulatory functions include:

- The Insurance Regulatory Information System (IRIS)
- The Financial Analysis and Tracking System (FAST)
- The Examination Tracking System (ETS)

One of the developments that underlie some of these systems is the expansion of insurers' statutory annual and quarterly financial statements and a computerized NAIC database containing most of the data reported by insurers. Most of these data address financial or solvency issues, but some of these data also are of value to market conduct surveillance.

To further assist market conduct surveillance, regulators have worked on a market conduct annual statement. **[Need to check status and use of this]** This recognizes the special data needs of market conduct regulators and the difficulties involved with satisfying both market conduct and financial regulation needs in one reporting document.

MARKET CONDUCT REGULATION STANDARDS

In the late 1980s, the NAIC developed financial regulation standards and an accreditation program for insurance departments. This was motivated by the recognition of the states' interdependence in financial regulation and the concern that some states needed guidance to improve the quality of their financial regulation. The wide acceptance and perceived success of the financial standards and accreditation program prompted a proposal for a similar system for market conduct regulation in 1991.

The proponents of this system argued that state insurance departments should meet certain minimum standards for market conduct regulation and the NAIC promulgation of such standards would help the states determine what they needed to do. However, their proposal faced several obstacles. First, at that time, many NAIC members believed that it was necessary to prioritize reform efforts towards financial regulation and that market conduct regulation standards would draw resources away from these efforts. Second, the interdependence of states is less obvious in market conduct regulation than in financial regulation. Third, market conduct regulation is perceived as more state specific and hence less amenable to national standards.

Consequently, after considerable debate, the NAIC did not adopt and move forward with a market conduct standards and accreditation program. Some of the energies that would have been used in developing such a program were probably channeled into other market conduct initiatives discussed above. Still, it is a concept that may resurface in the future. If it does, it may regenerate the debate about the advantages of greater uniformity versus industry concerns about causing states to unnecessarily increase the scope and stringency of market conduct regulation.

G. SUMMARY

Insurance market conduct regulation has come a long way since the early 1970s when it was largely confined to rate examinations. The McKinsey study and subsequent NAIC activities provided the first model system for market conduct surveillance. This model system has continued to evolve over the last 25 years as many states greatly enhanced their market conduct activities. Recommended regulatory policies and procedures have become much more sophisticated as experienced has been gained and the industry evolved. Many might agree that these refinements have contributed to exam efficiency and effectiveness. Views on the desirability of the expanded scope of market conduct exams may differ, however. Also, there may be concerns that the “best practices” recommended by the NAIC are not always followed by the states in reality. Variation in state practices has continued and is viewed positively by some and negatively by others. We now move to an overview of the insurance industry and its current regulation.

V. SUMMARY OF OBSERVATIONS

There is an extensive range of activities, topics, and views in insurance market conduct surveillance. In this initial report we have done our best to establish a context for the study of market conduct examinations and present the results from our surveys of regulators and insurers and other information sources. A preliminary version of this report was presented to the Insurance Legislators Foundation and the National Conference of Insurance Legislators and released for public comment in February 2000. We have received limited comments to date on the preliminary report. We have reviewed these comments and further examined our survey results. This second draft of our report reflects this work. We expect to receive additional comments at the ILF/NCOIL hearing on this study on July 6, 2000 and some further revisions may be warranted based on these comments.

We view the July 6 hearing and the completion of this report as the first stage in a multi-stage process of study, discussion, recommendation and implementation to improve insurance market conduct surveillance. While this report lays an important foundation, we need to further explore the implications of the information obtained and integrate this analysis with a broader and sustained process of inquiry and policy development. The NAIC's recently established Market Conduct Issues Working Group will be an important vehicle in this process. It is unrealistic to expect substantive change to occur without the strong commitment of all key stakeholders.

In keeping with the progressive nature of this public inquiry, we are cautious in making judgments about the efficacy and efficiency of current policies and systems. We offer observations about certain aspects of the current system that may warrant further examination and reform. Identifying a particular area or issue does not imply that related regulatory activities should be changed; further analysis may reveal that current regulatory practices are appropriate. Also, it should be noted that efficient policies and procedures in many areas are already reflected in NAIC model documents. Hence, the realization of "best practices" in the various states is as important as their refinement at a national level.

Our observations on several important topics, which are based primarily upon information contained in the Findings Section (Section IV), follow.

A. PHILOSOPHY AND PURPOSE OF MARKET CONDUCT SURVEILLANCE

Regulators' views 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. The philosophy governing market conduct surveillance is reflected in statements that first appeared in the McKinsey report and subsequently appeared in various editions of the NAIC Market Conduct Examiners Handbook (Handbook). It should be stressed, however, that these statements reflect an ideal vision of market conduct surveillance adopted by the NAIC. Individual state insurance departments and regulators may have different visions of this process. Moreover, regulators face a number of realities in implementing their responsibilities and actual practices may vary from ideal notions.

The basic issue is the purpose and relative emphasis of market conduct examinations. Should the sole or primary emphasis be detecting and correcting illegal or unfair business practices, or should examinations also look for and correct inadvertent errors in insurers' transactions? Some insurers express the concern that some state insurance departments place too much emphasis on inadvertent errors.

Initial statements of purpose in the McKinsey Report and the first examiners handbook strongly asserted the importance of emphasizing general business practices. The current articulation of the philosophy of

market conduct surveillance in the Handbook still reflects this view, although it has been moderated. It states:

> *The market conduct 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 examinations should concentrate on an insurer's general practices.*

Approximately 18 percent and 15 percent of the CEs and EICs surveyed disagreed with this statement. Based upon their experience with the examination that was the subject of the survey, approximately 25 percent of the insurers surveyed believed that the state insurance department did not conduct the subject market conduct examination in a manner consistent with this statement. These statistics suggest that only a minority of states and regulators, albeit a sizeable minority, have a different view of the purpose of market conduct exams than that espoused by the NAIC. How regulators' views may differ, why they differ, and how actual practices conform to regulatory philosophies are questions for further study. The fact that there is even this level of disagreement on this fundamental point after 25 years of regulatory activity is interesting.

In further comments, some regulators noted that isolated violations or errors could be severe and warrant detection and correction. Several also commented that random errors could be indicative of problems with company systems and procedures. In this respect, it appears that market conduct exams are sometimes used as a means to find and correct inadvertent company transaction errors. This begs the question of why regulators perform this "quality control" function, rather than insurers. There may not be a simple answer.[1]

Some survey respondents indicated that the purpose of market conduct examinations was to determine compliance with the law and regulations. However, compliance with the law is not so much as an end in itself but a means of achieving fair treatment of policyholders and claimants. Any efforts to improve the system of market conduct surveillance and make it more effective and efficient need to be grounded in a clear definition and a common understanding of the system's purpose.

B. Staff and Contract Examiners

The training, qualifications and performance of market conduct examiners have been a matter of interest since the mid-1970s. The McKinsey report stressed the need for trained professionals with special expertise to perform market conduct examinatrions. The Missouri and Illinois reports subsequently reaffirmed this view and recommended specialized training programs for examiners. The NAIC Handbook outlines the types of personnel that should be utilized in examinations and examiner qualifications based on IRES certification programs. The use of contract examiners also has been an issue, with the questions surrounding their relative cost, suitability and effect on the intensity of regulatory activities.

Our survey indicates that 13 states utilize contract examiners to perform market conduct examinations. These contract examiners may be individuals or firms. The number of contract examiners utilized varies dramatically, in both absolute and relative terms, among the state insurance departments. The average

[1] To elaborate, because of limited resources, some insurers, particularly smaller companies, may have relied on regulatory monitoring and directives to help manage their operations and correct errors. Also, if insurers anticipate that regulators will review the correctness of their transactions, they may reduce their own quality control procedures to avoid duplicative efforts. This would imply that regulator-insurer coordination is needed to ensure an efficient delegation of quality control and auditing tasks.

number of contract examiners used is four (4), but one CE reported using 44 contract examiners. Also, one third of the CEs reported an increase in the number of contract examiners used.

Chief market conduct examiners offered several reasons for using contract examiners rather than department staff. These reasons included an insufficient number of staff examiners, lack of required expertise within the department, and workload demands. The insurers surveyed did not perceive a marked difference in the qualifications and competency of contract versus staff examiners.

Most contract examiners are compensated at rates different than those set forth in the NAIC Handbook or state regulations.

The use of contract market conduct examiners has evoked some controversy, as it did with financial examiners many years ago. In some cases, contract examiners are viewed as a threat by staff examiners. One question that has surfaced is whether contract examiners should be used for routine, comprehensive examinations or only targeted examinations when staff examiners are not available. Insurers sometimes complain that contract examiners are more costly than staff examiners. Some also contend that the use of contract examiners allows government oversight to expand beyond the resources provided through the legislative process. This is a complex issue that does not lend itself to easy resolution. 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 use of contract examiners causes any significant, pervasive problems or reflects a fundamental weakness of the current system. On the contrary, if used appropriately, contract examiners may have a positive effect on system efficiency because of their expertise and flexibility.

The survey responses provided some interesting results concerning the qualifications and training of market conduct examiners. It appears that approximately 50 percent of the states responding to the survey do not use the staff classifications listed in the NAIC Handbook. It also appears that a significant number of the staff market conduct examiners do not meet the qualifications outlined in the NAIC Handbook.

At the same time, insurers surveyed indicated that they believed that the staff and contract examiners' qualifications are adequate and/or more than adequate for the job, with a slightly higher perception going to staff examiners. CEs indicated that contract examiners qualifications are generally the same or more extensive than staff examiners.

Less than one-half of the state insurance departments surveyed require the staff to attend NAIC training, IRES Career Development Seminars or the IRES curriculum for AIE or CIE designation. In addition, less than 40 percent of the EICs surveyed attended NAIC training, IRES Career Development Seminars or the IRES curriculum for AIE or CIE designation. However, the majority of the EICs believe that the training they receive is adequate for their responsibilities.

Approximately 25 percent of the state insurance departments charge time related to staff members' on-the-job training to insurers.

It is difficult to reconcile the department responses on the training and qualifications of examiners and the insurers' opinion of the competency of the examiners they have dealt with. While many examiners may fail to meet the desired qualifications, it does not appear that this has had a significant negative effect on examinations from the perspective of insurers. Hence, it is not clear that greater regulatory expenditures on training examiners would necessarily improve the quality and efficiency of examinations. Of course, regulatory and insurer views on examiner competency and what constitutes a "good" exam may differ and improved training could improve exams from a regulatory perspective.

C. 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 examinations might be that other sources of information, such as complaint data, and targeted examinations are insufficient to police market practices and detect all significant violations. The concern of insurers is that many routine examinations are unnecessary and impose excessive costs.

It appears that the majority of market conduct exams are targeted exams and their relative number is increasing over time.[2] 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. Surprise examinations still occur as three of the insurers interviewed indicated that they had been subject to a recent surprise examination. More than one state insurance department has performed a market conduct examination on the insurers surveyed during the last three (3) years. In addition, the insurers have undergone more than one (1) market conduct examination in the last three (3) years.

CEs indicated that internal complaint analysis was the most frequent trigger for performing a market conduct examination. Approximately 80 percent of the CEs indicated that either they or the Commissioner were the primary decision maker in determining which insurers undergo a targeted market conduct examination.

Insurers believe there is duplication of effort and overlap and, in some cases, a significant amount of duplication of effort and overlap by the various state insurance departments performing market conduct examinations. Furthermore, insurers believe that the states fail to adequately coordinate their market conduct exams. In contrast, the states greatly coordinate the financial examination of insurers operating in several jurisdictions through the NAIC Zone Examination System. Thus, unnecessary duplication is avoided. A factor impeding coordination may be the lack of consensus on the purpose of market conduct surveillance, as previously discussed.

An interesting finding was that approximately 25 percent of the state insurance departments surveyed use “testing” methods that involve department staff or others pose as consumers to assess insurers’ market practices. This is an alternative means to detect market conduct violations that appears to be used more extensively than we had anticipated.

As the NAIC and the states continue to increase and refine their use of complaint systems and other information sources, the triggering of market conduct exams may further improve. The growing use of targeted examinations also appears to be a positive development. The most important remaining problem appears to be lack of coordination among states and duplicative examinations of insurers. The different opinions on whether multiple states with different laws can rely on a common or coordinated examination likely contributes to this situation. Resolving this issue will be challenging but could substantially lower costs for insurers and regulators.

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[2] The insurer survey may appear to contradict this finding as approximately 79 percent of the insurers indicated that the subject examination was a comprehensive examination. However, this is due to the exams we selected and is not representative of the general pattern. The data suggest that the majority of market conduct exams are targeted exams and their relative proportion is increasing.

D. Examination Preparation and Communication

The Handbook stresses good examination preparation and communication with insurers and other states to enhance efficiency. Examination planning appears to be standard operating procedure and notification of insurers may be adequate, but other communication efforts may have room for improvement.

Chief and examiners-in-charge indicated that they almost always prepare a work plan and budget, but they are often not shared with insurers. Twenty-nine percent of the CEs and 27 percent of the EICs responded that they never share the work plan and time budget with the insurers. With respect to the subject examination, insurers indicated that the work plan was not shared with them 42 percent of the time and the time budget was not shared with them 67 percent of the time. This makes it more difficult for insurers to plan and prepare for exams.

The NAIC maintains an Examination Tracking System (ETS) for 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 CEs and EICs, respectively, responded that they always use the NAIC (ETS) to schedule a market conduct examination. Further, 43 percent and 38 percent of the CEs and EICs, respectively, indicated that they never use the ETS. Some examiners may perceive that ETS is less useful for market conduct exams if they perceive that state coordination and communication is less valuable for market conduct exams.

The adequacy of notifications and requests for information to insurers is less clear. The advance notice given to insurers does not appear to be an issue. More than 90 percent of the examiners responded that a notification letter is sent to an insurer at least one month prior to the insurer's examination. Sixty-five percent of the insurers indicated that they received the notification letter at least one month prior to the examination. The difference between regulatory and insurer responses could be due to sample bias or the mail system.

The completeness of notification letters may be more of a concern. The CEs and the insurers responded that notification letters typically include a list of items, such as the name of the state insurance department's examination coordinator. However, there is other information, such as the intent to use audit software, which is often (less than 50 percent) not included in notification letters.

The time allowed for insurers to respond to regulatory information requests also may an issue for some. Approximately 19 percent of the insurers believe that the time frame for responding to state insurance department requests is too restrictive, whereas none of the surveyed examiners believe that the time frames of their requests are unreasonable. It may be difficult to fully reconcile regulatory and insurer notions of what is a reasonable, but greater regulatory awareness of the time required to respond to certain requests could be helpful.

E. Scope of and Efficiency of Examinations

The scope of examinations has been a particularly significant issue, at least with insurers. Insurers have expressed a concern that the scope of some examinations is too broad and ventures into areas that do not require or are not suitable for regulatory review. Regulators may have a much different view of this issue.

The CEs indicated that five of the seven areas listed in the survey were always included in an examination. Company operations and management and producer licensing were the two areas not always included in an examination. From the insurers' perspective, underwriting was the only area that is always included and company operations and management was the area that was most often not included in the subject examination.

EICs believe that insurer appointment of a liaison is the most critical factor for achieving an efficient examination. The EICs also listed several items that state insurance departments and insurers could do that would result in more efficient examinations. These items include:

- Providing adequate office space;
- Having files pulled and ready for review;
- Proper documentation;
- Explanation of company information technology; and
- Timely responses to information requests.

The CEs indicated that examination findings, insurer response time and information from external sources were the most likely causes for the scope and time budget of exams to expand.

We also inquired about regulators use of technology in performing market conduct examinations. Our survey shows that almost all state insurance departments use computer applications on market conduct examinations. Insurers are split almost 50/50 on whether the use of this computer technology has made the examination process more efficient over the last three years. What contributes to this remarkable result would be a matter of importance for further investigation. A relatively recent development is the use of desk audits in lieu of on-site examinations or to determine the scope of on-site examinations. Improvements in technology facilitate desk audits. Seventeen of the twenty-eight surveyed chief examiners responded that they use desk audits. It also is interesting to note that in the comments section of the survey, a number of examiners indicated a desire for increased access to and training in automated exam technology.

F. Use of Insurer Compliance and Self-Assessment Activities

Insurers have received an important message from the courts and regulators with respect to business ethics and customer satisfaction and value. As a result of class action lawsuits and regulatory sanctions concerning sales abuses, redlining and other market practices, insurers have sought to improve their compliance activities and the treatment of policyholders. These initiatives include the 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 assessement 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.

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 Insurance Marketplace Standards Association (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. Only 15 percent of insurers believe that their self-assessment efforts would reduce the scope of market conduct examinations.

These findings raise some interesting questions. Presumably, insurer efforts to improve their market conduct are desirable. Do such efforts provide opportunities to modify examination processes to make more efficient use of regulatory resources? Does the current regulatory view of insurer self-assessment discourage or not encourage such self-assessment, and if so, what is the ultimate impact on the treatment of consumers?

G. COST OF EXAMINATIONS

The costs of the market conduct examinations, including direct and indirect costs to insurers, is a matter of concern to both the industry and state governments. Examination costs can be divided into three categories: 1) direct regulatory expenditures and the associated infrastructure; 2) the direct costs paid by insurers involved with undergoing an examination; and 3) indirect costs to insurers that stem from regulatory surveillance activities. 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 necessary regulatory tasks; and 2) the performance of unnecessary 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 is beyond the scope of this report. At best, we can offer some observations about examinations are funded and insurer perspectives on costs.

Our survey found that the examiner salaries are generally paid by state government except for contract examiners whose hours and expenses are billed to the insurers they examine. Insurers also tend to pay the travel expenses of staff examiners.

The use of contract examiners raises a “legislative authorization” issue not discussed above. Direct insurer billing of contract examiner costs could enable an insurance department to expand into regulatory activities through “off budget” expenditures not under the control of the state government appropriation and expenditure process. Insurance departments need the flexibility to utilize contract examiners when special needs arise, but their use for routine matters may require legislative scrutiny.

The cost to insurers for a market conduct examination consists not only of the direct payment of examiner salaries and expenses, but also various internal costs. These include the personnel costs of the individuals who respond to questions and provide data and files, office space and supplies, extracting data from computer files, and office equipment, among other items. In addition, there are other indirect costs such as the impact on daily processing and operations caused by the disruption and distraction resulting from the examination staff and activities. However, the majority of insurers surveyed did not view these costs as very significant. Only 16 percent of surveyed insurers indicated that these indirect costs can be fairly significant and 62 percent indicated that these costs were not very significant.[3]

[3] Insurers were asked to characterize the significance of indirect costs on a scale of 1-5, with 1 being very significant. The breakdown of responses was as follows: 1-3.5 percent, 2-12.9 percent, 3-21.2 percent, 4-35.3 percent, and 5-27.1 percent.

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% of the 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 examination 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.

H. 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 result from random human mistakes to systematic errors which 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. This suggests that sanctions or remedies may vary for similar violations.

I. Areas for Improvement

Insurers, Chief Examiners and Examiners in Charge we asked about what potential improvements to their market conduct examination process they consider most important. The Chief Examiners suggested the following:

- Automating the examination process
- More training for examiners, including technical training, that would complement automation of the examination process
- Communicating with companies and the public about the benefits of market conduct examinations
- “Streamlining” the process in order to reduce the amount of time and costs that examinations incur
- More expedient completion of the process after filed work is complete
- Hiring more Market Conduct Examiners
- Increased authority for examiners
- Improved communication with insurers; better process for administrative action
- Improved protection for confidentiality of work papers

The insurers suggested the following ideas for improving the process:

- Better training for examiners in the areas of law, specific types of insurance, company operations and computer technology
- A few examiners commented on examiner behavior: one would like examiners to be more courteous, and three suggested examiners should work more efficiently and be more organized
- Several insurers commented on the length and cost of the examination. Nine companies believed the examination period was too long. Two believed that pulling fewer files or starting work before arriving on-site could help shorten the review period. Four insurers viewed the costs as too high – two of those four see the examiners costs as excessive. One insurer would like the process to adhere more closely to the budget and says state insurance departments should absorb costs when examiners' mistakes cause them to go over budget
- Notification and requests for data are another area of concern for insurers. Two insurers would like to see a more explicit notification letter, including policy numbers, issue dates and agent names. Five others would like to be notified earlier about the examination and the information they need. One insurer said examiners request data at the last minute, causing the process to drag out. Two insurers stated that examiners asked for data that was already filed with the department
- A few insurers indicated that examiners need to be more specific about information they would require for the examinations so that insurers can be better prepared
- A few insurers suggested findings should be documented more clearly. Another believed that individual random errors were documented in an overly detailed manner. Another suggestion was including the insurer's comments in the report.
- Two insurers believed that the number of examiners was too high for the type of examination conducted, and one thought examiners should visit the home office for full assessment of out-of-state companies. Two other insurers believed not using contract examiners would be beneficial to the examination. One believed there should be someone overseeing all the examiners.
- Two insurers believed departments should be less harsh in their fines. One said they were not given enough credit for improvement and the other believed too much emphasis is placed on minor errors. Another said they would like to see less bias in the hearing process. This insurer believed the company was prejudged before even presenting their case.
- Two insurers would like to see more coordination between state insurance departments.
- Two insurers suggested that computers used by examiners should be able to use industry software.

- One insurer believed that the state insurance department did not adhere to the examination intent. Another would like to have more communication before the process begins by getting time and work budgets.

- One insurer would like to see the focus shift towards investigation general business practices while another wants departments to concentrate on insurers with problems or complaints.

- One insurer indicated that laws should be re-examined and brought in line with e-commerce.

J. CONCLUSIONS

Insurers and others have voiced a number of concerns about market conduct examinations. Our initial study suggests that there are many positive aspects of the current market conduct surveillance system, and it has improved in several areas. Institutions such as the NAIC and IRES have developed model practices and training programs, which have undoubtedly contributed to better market conduct regulation. At the same time, our survey suggests that there are several areas and issues that warrant further investigation and possible remediation. In some instances, it may be a matter of certain states revamping their systems and procedures in accordance with the "best practices" recommended in NAIC model documents. In other instances, different views may need to be reconciled at the national level to foster reform at the state level.

The issues and concerns that resonate most strongly from our survey involve the scope of market conduct examinations and state coordination and communication. Concerns about regulator-insurer communication, incentives for insurer self-assessment activities and state enforcement actions also appear to have some substance. The full implementation of practices recommended in the Handbook could significantly improve state coordination. However, avoidance of duplicative examinations also will require consensus on whether one examination can serve the needs of multiple states with different laws. The issue of the appropriate philosophy and scope of market conduct exams will renew a long-time national debate. It also is not clear whether insurer concerns about examination scope stem primarily from its cost implications, or other negative consequences perceived by insurers.

The growing use of more effective exam triggers, targeted exams and information technology are positive developments that should be encouraged. This may be partly a matter of will and partly a matter of resource appropriation.

The use of contract examiners and examiner qualifications and competency do not appear to be significant problems. Acquiring and retaining qualified market conduct staff will continue to be a goal and challenge, but it is not evident that any perceived deficiencies in this area have had a substantial negative effect on the quality or efficiency of examinations.

VI. NEXT STEPS

The Foundation's decision to study the market conduct examination system was timely and important. As we previously indicated, we do not believe that there has been a comprehensive review of this system since the early 1970's when McKinsey and Company recommended to the NAIC that market conduct surveillance activities be separated from the financial examination activities. While state legislators and insurance regulators have made improvements in market conduct surveillance activities since then, an extensive range of disparate views and issues relating to this activity remain. Hopefully, this study will help to establish a context for further study of market conduct activities. It is clear however that further work is needed to analyze the data compiled, obtain additional information and further evaluate the issues before concluding the work related to the market conduct examination area.

The following sets forth some specific thoughts on additional work the Foundation may want to consider undertaking:

- **Further data manipulation**

  As a result of the various surveys conducted, we have obtained a host of data and information on market conduct surveillance activities. Time constraints have limited the analysis and study of this data that could be performed; therefore, the Foundation may want to consider futher research analysis of this database.

- **Survey of additional insurers**

  The number of insurers that were interviewed represents only a small percentage of carriers that were the subject of a market conduct examination in the last three years. Therefore, the Foundation may want to expand the number of insurers interviewed.

- **Review and analyze examiniations reports**

  We did not review any insurance department reports resulting from market conduct examiniations to evaluate the scope and findings of actual examinations or perform other analysis such as comparison to the survey findings.

- **Effectiveness of market conduct examinations**

  This study was not designed to determine whether the market conduct examination process as executed by the various state insurance departments was effective in protecting the insurance buying public at a reasonable cost. This is certainly a valid and important question. Essential to answering that question is how effectiveness can and should be measured. To our knowledge, niether the NAIC or any state insurance department has developed such measurements. The Foundation may want to consider further work in this area. One possibility would be to analyze consumer complaints over time to determine if there is any correlation between such ratios and market conduct examination activity.

- **Identify and review other financial institutions regulators procedures**

  Particularly with the recent passage of the financial modernization bill, the Foundation may want to determine how regulators of other financial institutions such as banks, credit unions, and investment firms discharge their regulatory responsibility related to market conduct surveillance.

- **Insurance Departments without a Separate Market Conduct Unit**

This study focused on the insurance departments that had a separate unit dedicated to performing market conduct examinations. It would be interesting to determine why sixteen (16) state insurance departments believe they do not need a separate unit and how they discharge their regulatory responsibilities related to market conduct surveillance. In addition, it may be interesting to compare survey results of insurers that were subject to market conduct examinations by departments that did not have a separate unit to the survey results for those insurers that were subject to market conduct examinations by departments with separate units. In the course of this review, we did determine that at least one state insurance department did not believe such a unit was necessary since they have instituted another method. Their approach is to conduct a full-blown legal investigation and hearing when they suspect that an insurer is substantially and significantly improperly discharging its obligations to policyholders or otherwise involved in illegal tactics.

VII. SURVEY METHODOLOGY

This study included four data collection efforts. First, we attempted to contact the Department of Insurance in each of the 50 states, the District of Columbia, and the four territories to request organizational and background information and documents. Next, we attempted to conduct an in-depth-interview with the CE in each insurance department with a separate MCU. We then attempted to conduct an in-depth-interview with an EIC for each MCU. Finally, we interviewed insurers chosen at random from lists, provided by the state insurance departments, of market conduct examinations performed in the past three years.

Before any of the data collection efforts began, the project was introduced to the states, the district, and territories by NCOIL as well as by PwC. The three communications were:

- The project and its purpose was announced during the February 1999 NCOIL Spring Meeting and Seminar in Savannah.
- NCOIL President David Counts sent a letter dated May 10, 1999 to all 55 state, district, and territory Directors of Insurance. The letter explained the purpose of the review and introduced James Schacht of PwC as the project leader, and Dr. Robert Klein of Georgia State University as the project advisor and contributor.
- PwC mailed a letter dated June 29, 1999 to the Chief Examiners of the 55 state, district, and territory offices. The letter briefly explained the purpose of the study and referred to the May 10 letter.

A. REQUEST FOR ORGANIZATIONAL INFORMATION AND DOCUMENTS

The goal of the initial phase of the project was to contact each insurance department and determine which departments had a separate MCU. For each department with a separate unit, we asked about the structure of the unit and its use of the NAIC model law and manual. We also requested copies of the following information:

- statutes, regulations, bulletins
- market conduct examination procedures and policies
- department of insurance organizational chart
- department of insurance annual report
- internal policies and procedures
- detailed information about market conduct examinations conducted since January 1, 1997
- any other relevant material

The data collection instrument was developed by project team members from the SRC, the IRSP, and was reviewed by the project advisor, Dr. Robert Klein. The data collection instrument for this phase of the project can be found in the Appendix. Interviewers from the PwC SRC began calling CEs of the state insurance departments on July 6, 1999.

This phase of the project remained active from July to October 1999. We placed numerous calls to those departments that never responded and to those departments that agreed to send materials but never did. Departments were contacted by phone, fax, and e-mail. Exhibit 7-1 summarizes the results of our attempts to contact each of the departments. The department with a separate MCU that declined to send any materials is Connecticut. New Hampshire, Ohio, and Rhode Island agreed to send materials but did not.

Guam, Hawaii, Idaho, Massachusetts, Nevada, Puerto Rico, and Samoa did not respond to our contact attempts.

Exhibit 7-1: Response to Request for Organizational Information and Documents

	Number of Departments
Separate MCU – Sent Materials	28
Separate MCU – Declined to Send Materials	1
Separate MCU - Agreed to Send Materials But Did Not	3
No Separate MCU	16
Did Not Respond to Any Contact Attempts	7
Total	**55**

B. Interview with Chief Examiners

We attempted to conduct in-depth-interviews with CEs from each of the 32 department with separate MCUs. The goal of the interview was to understand the way in which market conduct examinations were administered by the department.

The data collection instrument was developed by project team members from the SRC, the IRSP, and the project advisor. The final data collection instrument can be found in the Appendix.

On August 24, 1999, interviewers began calling the MCU contacts to set an appointment for the interview. After setting up the appointments, copies of the questionnaire were faxed to each respondent.

The first interview was on August 31. Generally, the interviews were completed in 45 minutes to an hour; however, some lasted up to two hours. Many departments requested a conference call with multiple department employees. Some respondents chose to dictate their answers without hearing the questions, based on the faxed version of the data collection instrument. One state, rather than conducting the phone interview, chose to fax in their answers. The last interview was conducted on November 2.

Exhibit 7-2 summarizes the results of the CE interviews. Ohio and Rhode Island were not able to be scheduled. Connecticut and Vermont declined to participate. We conducted interviews with the following states: Alaska, Arizona, California, Colorado, District of Columbia, Delaware, Florida, Illinois, Kansas, Kentucky, Louisiana, Maryland, Minnesota, Missouri, North Carolina, North Dakota, Nebraska, New Hampshire, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Virginia, Washington, and Wisconsin.

Exhibit 7-2: Response to CE Interview

	Number of Departments
Interview Conducted	28
Not Able to Schedule	2
Declined to Participate	2
Total	**32**

C. SURVEY OF EXAMINERS-IN-CHARGE

In order to explore what happens in the field, we attempted to conduct in-depth-interviews with EICs or equivalent respondents from each of the 28 MCUs that participated in the CE interview. The data collection instrument was developed based on the instrument used in the CE interview. Some questions were removed, some reworded to reflect individual experience rather then department policies, and a few questions about field experience conducting market conduct exams were added. The final data collection instrument can be found in the Appendix.

The EICs for this phase of the study were identified by contacting the 28 respondents who completed a CE interview and requesting a list of names and phone numbers of the departments' EICs. As shown in Exhibit 7-3, some states did not have an EIC or the EIC had participated in the CE interview. Alaska was not able to be scheduled. Virginia declined to provide a list of EICs. Oklahoma agreed to send a list but did not. New York and Pennsylvania did not respond regarding their decision to send a list of EICs. We conducted interviews with EICs from the following states: California, Colorado, Florida, Illinois, Louisiana, Maryland, Missouri, Nebraska, New Jersey, North Carolina, Texas, Washington, and Wisconsin.

Exhibit 7-3: Response to EIC Interviews

	Number of Departments
Interview Conducted	13
Not Able to Schedule Interview with EIC	1
No Department Staff to Interview	7
EIC Participated in CE Interview	3
Declined to Provide List of EICs	1
Agreed to Send Names But Did Not	1
Did Not Make Decision Whether to Send Lists	2
Total	**28**

Of the 14 states that provided names of their EICs, two sent only one name. One name was selected at random from each of the other 12 states. On September 29, 1999, SRC interviewers began calling each EIC chosen for the sample to set up a time to conduct the interview. Six CEs and one EIC requested a fax copy of the questionnaire before scheduling their interviews.

The first interview was held on September 30. The interviews were generally completed in 25 minutes. In contrast to the CE interviews, most of the EIC interviews involved only the EIC and the SRC interviewer. The EIC interviews were completed on October 27.

D. SURVEY OF INSURERS

To understand the market conduct examinations process from the insurers' perspective, the final data collection phase was a survey of insurers that have undergone a market conduct examination. The SRC, the IRSP, and the project advisor designed the questionnaire based on the data collection instrument used in the CE interview. Questions were added to address topics such as examination burden and types of errors found.

A pretest of the questionnaire was conducted with two insurers. After completing the pretests, the respondents were asked five follow-up questions to gauge their overall opinions about the questionnaire, including the clarity and suitability of survey questions. The final data collection instrument can be found in the Appendix.

During the initial request for information, departments with MCUs were asked to provide a list of market conduct examinations conducted since January 1, 1997. The sample of insurers was selected from the lists of market conduct examinations provided by the following 26 states: Alaska, Arizona, Colorado, Delaware, District of Columbia, Florida, Illinois, Kansas, Kentucky, Louisiana, Maryland, Missouri, Nebraska, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Vermont, Virginia, Washington, and Wisconsin. Of the 28 CEs interviewed, 25 sent a list of market conduct examinations. California and Minnesota did not due to confidentiality concerns, and New Hampshire agreed to send theirs but never did. Although Vermont declined to participate in the CE interview, Vermont did send a list of market conduct examinations.

The sample was selected in an effort to complete 100 interviews and meet the following criteria:

- Conduct one interview with a Life/Health and one with Property/Casualty insurance company from each state insurance department.
- Conduct additional interviews proportional to the number of market conduct examinations submitted by the state insurance department.

Insurer contact information was obtained using the company name or the NAIC number, if provided by the state insurance department, from a BEST database. If the insurer was not listed in this database or could not be readily located using a different source, the examination was replaced by another examination.

On November 20, SRC interviewers began contacting insurers in order to establish a contact person – the person who could best answer questions about market conduct examinations. Generally, the contact person was identified by talking to someone in a Government Relations, Compliance, or Regulation Department.

The contact person was faxed a letter explaining the purpose of the study and the contents of the questionnaire. Shortly after sending the fax, an interviewer called to set up an appointment to conduct the

interview. The first interview was held on December 16, 1999. The average length of an interview was approximately 30 minutes. A total of 85 interviews were conducted. The 85 interviews represent 78 companies. Due to time constraints, interviewing ended February 4, 2000 and we were unable to complete the full 100 interviews initially targeted. Exhibit 7-4 details the final result of each examination selected.

Exhibit 7-4: Response to Survey of Insurers

	N of cases	Percent
Complete	85	37.0%
Unresolved at the End of Data Collection	51	22.2%
15 Attempts to Contact	8	3.5%
Declined to Participate	32	13.9%
Confidentiality Concerns	4	1.7%
Company Policy Not to Participate in Surveys	9	3.9%
No One with Knowledge of Exam	23	10.0%
Unlisted/No Contact Found	18	7.8%
Total	**230**	**100.0%**