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Report to the Chairman, Committee on Financial Services, House of Representatives

September 2003

INSURANCE REGULATION

Common Standards and Improved Coordination Needed to Strengthen Market Regulation

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Highlights

Highlights of GAO-03-433, a report to the Chairman, Committee on Financial Services, House of Representatives

INSURANCE REGULATION

Common Standards and Improved Coordination Needed to Strengthen Market Regulation

Why GAO Did This Study

Consumers of insurance depend on state regulators to ensure that insurance companies are behaving fairly and in accordance with the law. This report evaluates the states' use of market analysis (information gathering to determine issues and identify companies that may need attention) and on-site examinations in market regulation and the progress the National Association of Insurance Commissioners (NAIC) has made in creating more uniformity in the regulation of market conduct.

What GAO Recommends

GAO recommends that NAIC and the states give increased priority to identifying a common set of standards for a uniform market oversight program that includes all states. These standards should include procedures for conducting market analysis and coordinating market conduct examinations. Further, NAIC needs to establish a mechanism to encourage state legislatures and insurance departments to adopt and implement the standards.

What GAO Found

Market conduct regulation—oversight of insurance company practices such as selling and underwriting policies—is the responsibility of the same state agencies that oversee insurance companies' financial solvency. Unlike financial regulation, however, with its nationwide standards that allow for coordination among state regulators, no generally accepted standards exist for market conduct regulation. While all states do some kinds of market regulation, including issuing licenses and responding to consumer complaints, two key tools—market analysis and on-site examinations—are used inconsistently, if at all. The result is inconsistent and often spotty coverage from state to state and potential gaps in consumer protection. Formal and rigorous market analysis, which could be used to determine which companies to examine and how broad the examination should be, is in its infancy among state regulators, and states that do perform examinations vary widely in the way they choose companies to examine and the scope of the examinations they conduct. These inconsistencies in performing market conduct examinations make it difficult for the states to depend on each other for regulation, leaving each state with the virtually impossible task of examining every company within its borders. And with each state conducting its own examinations, some insurance companies find themselves undergoing simultaneous examinations by several states, while other companies may not be examined at all.

NAIC has been pursuing initiatives since the 1970s to improve uniformity in standards and procedures for a market analysis program and market conduct examinations, but progress has been limited. In 1975 NAIC first published guidance for market conduct examinations and since then has updated it regularly. NAIC has also developed and continues to improve a tracking system that allows states to share examination schedules. But states are not required to use the guidance, although many do, and may choose which parts they wish to apply. Similarly, states are not required to use the tracking system, and most have not. The success of NAIC's initiatives will be determined in large part by regulators' willingness to share in these efforts and to rely on regulators in other states to assess an insurance operation. Recently, NAIC set as one of its major goals improving the way states use market analysis and market conduct examinations. However, it remains uncertain whether NAIC and the states can agree on and implement a program that will result in the standardization of market conduct regulation. Much work remains to be done to promote the coordination and cooperation that are needed for consistent market conduct regulation to protect insurance consumers.

www.gao.gov/cgi-bin/getrpt?GAO-03-433.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

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Abbreviations

ETS	Examination Tracking System
IRES	Insurance Regulatory Examiners Society
MAWG	Market Analysis Working Group
NAIC	National Association of Insurance Commissioners

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

September 30, 2003

The Honorable Michael Oxley
Chairman, Committee on Financial Services
House of Representatives

Dear Mr. Chairman:

Millions of American consumers rely on property and casualty insurance for protection from a wide range of perils and on life insurance to help guarantee the payment of mortgages, the education of children, and the general welfare of families after the policyholders' deaths. But choosing an insurance company and evaluating a policy are difficult tasks for most consumers, who generally do not have access to the information needed to make such comparisons. For this reason, insurance regulators are responsible for regulating not only the financial solvency of insurance companies but also their interactions with customers, or market behavior. Market regulation is designed to make sure that insurance companies are fair and nondiscriminatory in their dealings with customers, do not renege on the terms of their contracts, and write policies that offer what state laws require.[1]

Historically, state regulators have focused the majority of their time and resources on financial regulation, which oversees accounting methods and procedures and financial statements in order to verify that companies are in good financial condition and able to pay policyholders' claims. States generally have the systems and tools in place to regulate financial solvency, but market regulation is hindered by limited resources, a lack of emphasis on important regulatory tools, and the framework of the system itself, which requires individual states to oversee companies that operate in many states or nationwide. As a result, market regulation is currently based on overlapping and often inconsistent state policies and activities. While it provides some oversight, it may also place an undue burden on some insurance companies and, at times, may fail to adequately protect consumers.

[1]For the purposes of this report, we use *market regulation* to mean the set of regulatory processes and tools focused on an insurance company's interactions with its customers.

The Congress has long been concerned with the need for the states to improve the quality and uniformity of insurance regulation. As you requested, this report provides information on state insurance regulators' oversight of market activities in the insurance industry and emphasizes how the states use market analysis and on-site examinations as regulatory tools.[2] Market analysis consists of gathering information on a company, an agent, or a market and evaluating that information to identify issues, problems, and trends. A market conduct examination is similar to a financial solvency examination, with examiners visiting a company to evaluate practices and procedures and check them against the company's files. Specifically, this report (1) evaluates the states' use of market analysis and on-site examinations in market regulation and (2) discusses the progress of efforts by the National Association of Insurance Commissioners (NAIC) to improve and coordinate market regulation at the state level.

To address these objectives, we collected data and interviewed officials from nine states' insurance departments—Arkansas, California, Indiana, Maryland, Michigan, Missouri, New Mexico, Ohio, and Oregon—and from NAIC's Kansas City headquarters. The states selected provide an array of experience with different models of market regulation and different levels of regulatory resources. Some of the states that we visited had market conduct oversight operations that varied from independent organizational units to units combined with financial oversight. The states we visited also varied in the total number of examinations performed. We also reviewed nationwide information on the market oversight activities of all states, including data on the level of regulatory resources, the number of market conduct examinations performed, and the number of licensed companies. To meet our first objective, we reviewed states' operating procedures for market analysis and on-site examinations and interviewed state officials responsible for these activities. We also asked a selected sample of 40 companies—20 each from among the largest 200 property and casualty firms (based on direct written premiums) and the largest 200 life companies (based on asset size)—questions about their experiences with market conduct examinations from 1999 through 2001.[3] To determine the

[2]We testified before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives. See U.S. General Accounting Office, *Insurance Regulation: Preliminary Views on States' Oversight of Insurers' Market Behavior*, GAO-03-738T (Washington, D.C.: May 6, 2003).

[3]Because our sample was nonstatistical, our results cannot be projected to all insurers.

effectiveness of NAIC's efforts to improve its market regulation program, we interviewed officials from NAIC, attended its national meetings to identify current issues in market regulation, reviewed past market regulation efforts, and reviewed past and current initiatives to improve the market regulation program. We conducted our review from April 2002 through August 2003, in accordance with generally accepted government auditing standards. Appendix I provides a more detailed description of our scope and methodology.

Results in Brief

Because no generally accepted standards exist for market analysis and market conduct examinations, each state decides how it will carry out these activities. As a result, few states have formal programs for market analysis, and examinations are used inconsistently and in some cases infrequently. While all states perform some type of market analysis, only three of the states that we visited had formal analysis programs. Further, each of the three states' programs was unique, and two of the programs were still in the developmental stage. We also found that the states had no generally accepted criteria for determining which companies to examine or which type of examination to perform. The nine states we reviewed did only a small number of on-site examinations relative to the number of companies operating in each state, and while variations in the number of exams often reflected differences in the levels of resources devoted to performing these reviews, the variations were not closely related to differences in the size of the insurance market. Information collected by NAIC showed that the number of examinations among the insurance departments in the remaining states were also low. Because states lacked common standards for market analysis and applied guidelines for examinations inconsistently, states did not coordinate examinations or depend on each other for help in regulating the market conduct of insurance companies and agents. These differences meant that some companies underwent frequent and expensive examinations while others were examined infrequently or not at all.

Over the years NAIC has initiated a number of efforts aimed at finding ways to facilitate uniformity in states' market analysis programs and promote interstate coordination in market conduct examinations. However, despite NAIC's long-standing efforts and some limited successes, progress has been slow. For example, in 1975 NAIC developed

a handbook for market conduct examiners, which is updated regularly.[4] The handbook provides useful guidance on conducting examinations and reporting the results, and most states use it to some extent. However, most states are not required to use it, and it does not contain standards such as when to hold examinations or how to choose companies to examine. NAIC also developed the Examination Tracking System (ETS), a computer-based system designed to help states coordinate examinations and thus reduce the regulatory burden on insurers. Using the ETS, state regulators should know when other states planned to hold examinations and which companies would be examined. However, because the states have not used the system widely, the hoped-for improvements in efficiency have not materialized as quickly as anticipated. NAIC continues its efforts to improve the ETS. Recently, NAIC leadership announced a major initiative to improve insurance regulators' use of market analysis and market conduct examinations. However, because progress in the past has been slow, results from the new initiative are still uncertain.

This report includes a recommendation that NAIC, working with the states, give priority to identifying a common set of standards for a uniform market oversight program that will include all states. These standards should include procedures for conducting market analysis and coordinating market conduct examinations. Further, we recommend that these standards be included in a program to encourage their adoption by states.

We received combined comments on a draft of this report from NAIC and the state insurance departments that we visited. NAIC stated that, "Overall, the report confirmed several concerns that state regulators and the insurance industry share about market regulation and particularly, market analysis and market conduct examinations." These comments are reprinted in appendix V, along with our comments. NAIC's comments are also discussed in greater detail at the end of this letter. NAIC and several of the states also provided technical comments, which we incorporated as appropriate.

Background

Insurance in the United States is an industry that generates $735 billion a year in premiums, with about 900 to 2,000 insurance companies providing policies for businesses, governments, and consumers in each state. In

[4]National Association of Insurance Commissioners, *Market Conduct Examiners Handbook*, vols.l and ll (Kansas City, Mo.: Spring 2001).

addition, 3.5 million individuals are licensed to sell insurance, including independent agents who sell and service insurance policies for at least two insurance companies, agents who sell and service insurance policies for specific companies, and brokers who represent buyers rather than companies by searching the marketplace for the best possible deals for their clients.[5]

States have primary responsibility for regulating the insurance industry, and each state has its own insurance department. NAIC, which is made up of the heads of the insurance departments from the 50 states, the District of Columbia, and 4 U.S. territories, provides a forum for regulators to identify and share best practices and develop recommended laws and regulations. NAIC also develops and operates information-sharing tools such as the ETS.

Market regulation requires state insurance regulators to oversee a wide range of company practices, including sales, underwriting, and claims processing and payment. Because of the scope of the market activities they must oversee, regulators perform a variety of oversight tasks that work together to help protect consumers from unfair practices. In addition to market analysis and market conduct examinations, these activities include

- approving the prices and contents of insurance policies in rate-and-form reviews,
- processing consumer complaints,
- issuing licenses to producers and companies, and
- providing consumer education.

According to the state regulators we spoke with, the rate-and-form review is a first step in protecting insurance consumers, allowing regulators to screen each product as it enters the market for price and coverage. During a rate-and-form review, state insurance regulators examine a policy's price, terms, and conditions for adherence to state laws and regulations. Most states' regulations stipulate that while prices for insurance products

[5]In this report, we use the term agent to refer to all individuals who are involved in selling insurance to the public, thus including both agents and brokers. The insurance industry and regulators use the term insurance producers.

may ensure a return sufficient to meet a company's expenses, pay its claims, and make a reasonable profit, they must also be low enough to be fair to consumers. Some states allow companies to begin selling policies before receiving approval for price and policy terms. In other states, regulators must approve policies and prices before policies can be sold. Recent efforts by regulators to speed up the product approval process may reduce the time and attention given to approving individual products.

States also generally have procedures for receiving and responding to consumer complaints and inquiries. Most states consider written grievances against a specific insurance entity, such as an insurance company or agent, complaints; general questions about rates and coverage are treated as inquiries. In 2001, states received nearly 470,000 complaints and over 3 million inquiries. Complaints currently serve an important function in the market regulation process, as they often offer regulators the only opportunity to identify specific problems in the industry and to establish patterns of behavior that help identify problems with companies and agents. For consumers, the complaint process is generally the most important—and often only—point of contact with an insurance company, regulators, or both. Generally, the complaint process includes acknowledging the complaint, screening it, and sending a query or investigative letter to the company or agent in question. The company or agent generally must respond within a certain period, after which the regulator reviews the response for consistency with the provisions of the contract and for violations of insurance laws and regulations of the state.

As another part of their market regulation responsibilities, state insurance departments issue licenses to companies and agents. In 2001, 3.5 million individuals were licensed to provide insurance services in the United States. Licenses vary by state, with some states issuing one type that covers all those who sell insurance and other states issuing separate agent licenses and drawing distinctions between the services each can offer. Most states have a prelicensing education requirement and an examination or similar requirement for demonstrating competence in the insurance field. Additionally, many states require agents and brokers to attend continuing education courses in order to maintain their licenses. However, state insurance departments generally do not routinely oversee the ongoing activities of agents, although insurance regulators do investigate and discipline agents identified through complaints. Insurance companies also have some responsibility for overseeing the behavior of agents selling their products.

Further, states provide consumer education that is intended to help protect the interests of insurance customers. These efforts may include informative brochures, rate comparison guides, and seminars, especially for senior citizens. These efforts are not consistent across states, with some states spending far more than others to help educate consumers.

Each of these oversight tasks helps protect consumers from unfair practices. However, market analysis and on-site market conduct examinations provide information on the actual practices of insurers. Market analysis is an important way for states to identify potential misbehavior by insurance companies, and on-site examinations provide the most systematic assessment of insurers' behavior and practices.

States Vary in How They Conduct and How Often They Use Market Analysis and Market Conduct Examinations

In the absence of generally accepted standards, individual states decide if and how they will do market analysis and perform market conduct examinations. All state insurance departments do some type of market analysis, gathering information about companies in the course of making regulatory decisions. But only a few of the states we visited had established formal market analysis programs designed to help identify problem companies earlier and more effectively. We found that those states attempting to do more formal market analysis had very different approaches that were for the most part still in a developmental phase. Similarly, we found that states had no generally accepted criteria for market conduct examinations that would help in determining which companies should be examined or how thorough an examination should be performed.[6] We found that states generally performed few examinations relative to the size of the insurance industry and devoted different levels of resources to their examination programs. The lack of common standards for market analysis and inconsistency in applying the guidelines for examinations made reciprocity among states and mutual acceptance of examination results difficult. And because the selection criteria and examination procedures differed across states, some companies were being examined frequently and others not at all.

[6]While the *Market Conduct Examiner's Handbook* includes a list of factors that a state could consider to prioritize companies for examinations, they do not constitute "generally accepted criteria" for determining when a company should be examined for two reasons. First, states are not required to follow the guidance in the handbook and may choose which parts, if any, they wish to apply. Second, the factors listed in the handbook do not provide clear and specific minimum standards for when and how these factors should be applied. As a result, states are unlikely to respond consistently to a given market conduct problem.

Few States We Visited Did Systematic and Routine Market Analysis

According to NAIC, market analysis provides an important tool for monitoring the broader marketplace, allowing states to identify regulatory problems and better prioritize and coordinate market regulation functions, and establishing an integrated system for responding to market problems. Among other things, market analysis can provide information on insurance companies' compliance with applicable laws and regulations, highlight practices that could have a negative effect on consumers, and help identify problem companies for examination. NAIC and some states recognize that market analysis can be a significant regulatory tool, and all of the states we visited performed some type of market analysis, but in most cases these efforts were fragmented and lacked a systematic organization and framework. We found that in many states market analysis consisted largely of monitoring complaints and complaint trends and reacting to significant market issues. Analyzing complaints and complaint trends does provide regulators with useful and important information and should be part of any market analysis program. However, other types of information can also help regulators identify and deal with market conduct issues, including data from financial reports, rate-and-form filings, other company filings, routine and special requests for company data, and information from other federal and state regulators. All this information, consistently and routinely evaluated by well-trained analysts, can help regulators identify companies that examiners need to look at more closely or that merit regulatory actions.

Regulators in some states also performed desk audits, often classified as a type of examination. For these audits, regulators rely on documents and files the companies send for review. When done in the regulators' offices, desk audits are actually a component of market analysis. When the review of company files is part of an examination that includes a visit to the offices of the insurance company, it becomes part of an on-site market conduct examination.

Three states that we visited—Missouri, Ohio, and Oregon—have established proactive and formal market analysis programs with processes for monitoring company behavior to identify market trends, firms that vary from the norm (outliers), and potential market conduct problems. Missouri has been doing market analysis for a number of years while the Ohio and Oregon programs are still in the developmental stages. The programs differed in their approaches.

- Missouri requires all insurance companies to submit supplemental market data reports along with their annual financial reports that include information on companies' activities. Regulators used these data and

numerous other sources to evaluate market trends and conditions and to identify companies that merited extra attention.

- Ohio gathers extensive information from selected company files that it requests and, using computerized audit tools, analyzes how companies' operations compare with norms identified by peer analysis and with state law. In most states, this activity, less formally done, is called a desk audit. Ohio did 184 of these "desk audits" in 2001 using data requested from companies doing business in the state. This process allows Ohio's regulators to identify companies meriting further regulatory attention that might otherwise have escaped notice.

- Under Oregon's newly established program, analysts collect, organize, and maintain data on companies. This information is drawn from various sources, such as complaints and Internet information, to facilitate a broad and ongoing review of company behavior.

Although the other six states we visited did not have formal market analysis programs, they all performed some type of market analysis. For example, all the states looked at complaints and complaint trends to identify potential problems.

States Varied in Their Approaches to Market Conduct Examinations

Because no generally accepted standards exist that stipulate how often or even how regulators should examine companies, market conduct examination policies and practices vary widely across the states. NAIC statistics show that not all states perform market conduct examinations, and among states that do, the criteria for choosing which companies to examine and what type of examination to use differ widely. As we have noted, in 1975 NAIC produced its handbook for market conduct examiners, but most states are not required to use the handbook, and those that use it voluntarily may decide which parts to apply. These differences in the way regulators select companies to examine and carry out the reviews make it difficult for regulators in one state to depend on the examinations done by other states and hamper coordinated regulatory oversight. Because states do not coordinate their market regulation

efforts, most state regulators feel responsible for overseeing all the companies operating within their borders.[7]

Because of the nature of state-level insurance regulation, however, coordinating market conduct examinations is important to efforts to improve oversight—for example, to alleviate the burden on individual states of examining every company within their purview. The importance of cooperation and coordination in the market conduct examination process has been widely recognized. The 1971 McKinsey study[8] recognized that insurance companies operations—and thus market regulation—frequently extended across state borders. The study concluded that it was critical for the states to share relevant market conduct information with other states and to coordinate examinations.

A July 2000 report[9] by PricewaterhouseCoopers, LLP also concluded that a lack of cooperation, communication, and coordination were significant issues in state regulation of the industry. The report found that insurers believe there is duplication of effort and overlap by state insurance departments performing market conduct examinations. The American Council of Life Insurers has also pointed out that there is very little coordination among states when conducting market conduct exams, even though in the case of financial regulation, including financial examinations, regulators have come to rely on the state in which a company is chartered.

Among the nine states we reviewed, the practice of coordinating exams with other states was not common and, when it did occur, varied substantially across states. Some states coordinated their examination plans with other states or reviewed other states' examination reports before exams. Some states have also started to perform joint examinations. For example, Ohio officials told us that they had started to

[7]Not all licensed companies in a state are actively selling insurance. For example, some companies with existing business may be going out of business, but still servicing existing customers in liquidation. These companies may still have some active policies in the state but are not selling any new policies.

[8]McKinsey & Company, Inc., *Strengthening the Surveillance System*, Final Report, a report commissioned by National Association of Insurance Commissioners, April 1974. McKinsey also issued preliminary reports in 1972 and 1973.

[9]PricewaterhouseCoopers, LLP, *Insurance Market Conduct Examination Public Policy Review*, Final Report prepared for The Insurance Legislators Foundation (Burlington, Vt.: July 6, 2000).

conduct collaborative examinations with Illinois, Nebraska, and Oregon, and officials from Oregon told us that they recognized the need for more interstate collaboration and reliance on examination results from other states. Indiana officials said that they had recently completed a joint examination of a large insurer with Colorado.

States Limited the Scope of Market Conduct Examinations

In general, on-site market conduct examinations fall into two categories: comprehensive examinations and targeted examinations. A comprehensive examination allows regulators to examine all or most of a company's operational areas, using files and documents from company data banks. For example, examiners can review types of products the company and its agents sell, agents' sales practices, claims payment mechanisms, underwriting standards, and policy provisions. Examiners can also review a company's internal controls—those processes designed to ensure that the company, its employees, and its agents adhere to all laws and company policies—and "test" them by checking them against the company's files. A targeted examination involves similar procedures but is limited to one or a few business areas.

All the states we visited limited the scope of their market conduct examinations. Most states limited the scope of their examinations by performing mainly targeted examinations—for example, by focusing on how a company processes claims, while largely ignoring underwriting, sales practices, or other activities. However, some states still do comprehensive market conduct examinations. Of the nine states we visited, Arkansas, Missouri, and New Mexico continued to conduct comprehensive as well as targeted examinations. Arkansas officials told us that they saw comprehensive examinations as important for domestic companies because they provide the most assurance that companies are complying with insurance laws and regulations. However, the officials indicated that they support the utilization of a targeted examination approach when examining foreign licensed insurers unless circumstances indicate a comprehensive examination is more appropriate. In every state we visited, however, including those states that did comprehensive examinations, the scope of examinations was further limited by restricting the examination to a review of files of only those insurance consumers living in the examining state.

Table 1 shows how many on-site market conduct examinations, both targeted and comprehensive, were performed in the states we visited and what percentage of insurers in each state the examinations covered.

Table 1: Market Conduct Examinations and Licensed Insurers in 2001

State	Market conduct examinations completed in 2001			Licensed domestic insurers[a]	Licensed nondomestic insurers[a]	Total licensed insurers	Percentage of insurers examined in 2001
	Targeted	Comprehensive	Total				
Arkansas[b]	2	17	**19**	245	1,423	**1,688**	1.10%
California	148	0	**148**	229	1,171	**1,400**	10.57%
Indiana[c]	4	0	**4**	183	1,588	**1,771**	0.22%
Maryland	15	11	**26**	90	1,393	**1,483**	1.750%
Michigan[d]	0	0	**0**	175	1,325	**1,500**	0.00%
Missouri[e]	2	27	**29**	141	1,500	**1,641**	1.77%
New Mexico	1	7	**8**	20	1,575	**1,595**	0.50%
Ohio	42	0	**42**	280	1,505	**1,785**	2.35%
Oregon	15	0	**15**	49	1,404	**1,453**	1.03%

Source: State insurance departments.

Note: Does not include follow-up exams or desk audits even though they are done under a state's audit authority. For example, Ohio did 184 desk audits during 2001 that did not result in an examination report. While desk audits are an important component of market regulation for many states, we have classified such off-site audits of company files as part of market analysis rather than as market conduct examinations.

[a]A domestic insurer is a company that is chartered under the laws of a particular state. For example, the (hypothetical) Acme Insurance Company could be licensed to sell insurance in all 50 states, but it is a Michigan domestic. A nondomestic insurer is a company that, while selling insurance in a particular state, is chartered under the laws of some other state. These companies are often called "foreign" companies to differentiate them from domestic companies. Thus, while in Michigan regulators would consider the Acme Insurance Company to be a domestic company, in all other states it would be a nondomestic or foreign company.

[b]Arkansas also examined 65 funeral homes' that sold prepaid funeral insurance.

[c]Three of these were multistate exams.

[d]We omitted 37 combined market conduct/financial examinations Michigan did in 2001 because of their limited scope and focus when it came to market conduct issues.

[e]Does not include Missouri's 123 mutual domestic companies since, by statute, the Missouri Department of Insurance cannot examine county mutuals.

According to NAIC, 49 states and the District of Columbia reported on their market conduct activities in 2001. Of these, 15 did only targeted examinations, 4 did only comprehensive examinations, and 22 did both. The remaining 9 did no market conduct examinations in 2001. State officials we interviewed indicated that they used targeted examinations more often because these examinations take less time, allowing regulators to do more examinations with existing resources. Some officials said, however, that the narrow scope of targeted examinations limited their

ability to fully assess a company's compliance with insurance laws and regulations.

Recently, phase 2 of the PricewaterhouseCoopers study reported that examinations as typically done by state insurance departments tended to focus too little on reviewing internal controls and systems for maintaining companywide compliance with laws, regulations, and ethical practices. Instead, market conduct examiners sometimes tend to look for isolated mistakes and errors by focusing on reviews of transactions files rather than looking for broad patterns or practices of error or illegality.[10] As a result, some insurance companies report their perception of comprehensive market conduct examinations as "fishing expeditions" that provide opportunities for insurance departments to levy fines rather than as regulatory tools designed to ensure the quality of insurer performance and service.[11]

States Used Different Criteria to Select Companies to Examine

Since there are from 900 to 2,000 insurance companies licensed to sell insurance in each state, regulators in the states we visited used a variety of criteria to choose which companies should be examined. The most commonly used factors for choosing from among the eligible companies were the state in which the company was chartered and the number and severity of complaints about the company. Regulators generally have the authority to do a market conduct examination on any company that sells insurance in their state. However, some states look only at domestic companies (those chartered in their states), even though the majority of the insurers selling in the state may be chartered elsewhere. For example, of the states we visited, Arkansas and Michigan focused primarily on domestic companies. In 2001, however, only 73 of Arkansas's 1,496 licensed companies were chartered in the state. As a consequence, 1,423 nondomestic companies, or 95 percent of all the companies that sold insurance to Arkansas's citizens in 2001, were not examined in Arkansas and might or might not have been examined in another state.

[10]The *Market Conduct Examiners Handbook* encourages examiners to focus on the "general business practices" of the examinee. The handbook also provides guidance on sampling techniques and recommended error rates that could, if consistently used, reduce the focus on isolated or inadvertent errors.

[11]PricewaterhouseCoopers, LLP and Georgia State University, *The Path to Reform—The Evolution of Market Conduct Surveillance Regulation*, preliminary report prepared for the Insurance Legislators Foundation, May 1, 2003.

Other states do not discriminate between domestic and nondomestic companies when it comes to deciding which companies to examine. Of the states we visited, California, Indiana, Maryland, Missouri, New Mexico, Ohio, and Oregon fell into this group. These states used a variety of other factors to select specific companies to examine. For example, all the states we visited considered complaints and complaint trends as a factor in targeting companies to examine. Indiana officials told us that while other factors could influence the selection process, they primarily used complaint data to identify potential problems and determine which companies should be examined. A company with several similar complaints, a rising trend of complaints, or even one particularly egregious complaint (for example, mishandling of customer premium payments) would be a legitimate examination target.

However, the use of complaint data has its limitations. One state regulator told us that his state does not rely on consumer complaints as the sole indicator of problems in the market because some kinds of problems and violations may not be visible to consumers, who may then be unaware that they have been subjected to unfair or deceptive practices, such as violations of disclosure laws and sales tax reimbursement requirements, rating errors, and unfair marketing strategies. The usefulness of complaints as an indicator of a serious problem may also vary with a company's primary line of business. Consumers are likely to have more frequent interactions with their automobile or health insurers than with their life insurance companies. As a result, an insurance department may receive more complaints about a property or health insurer than about a life insurance company, irrespective of how serious the potential infraction might be.

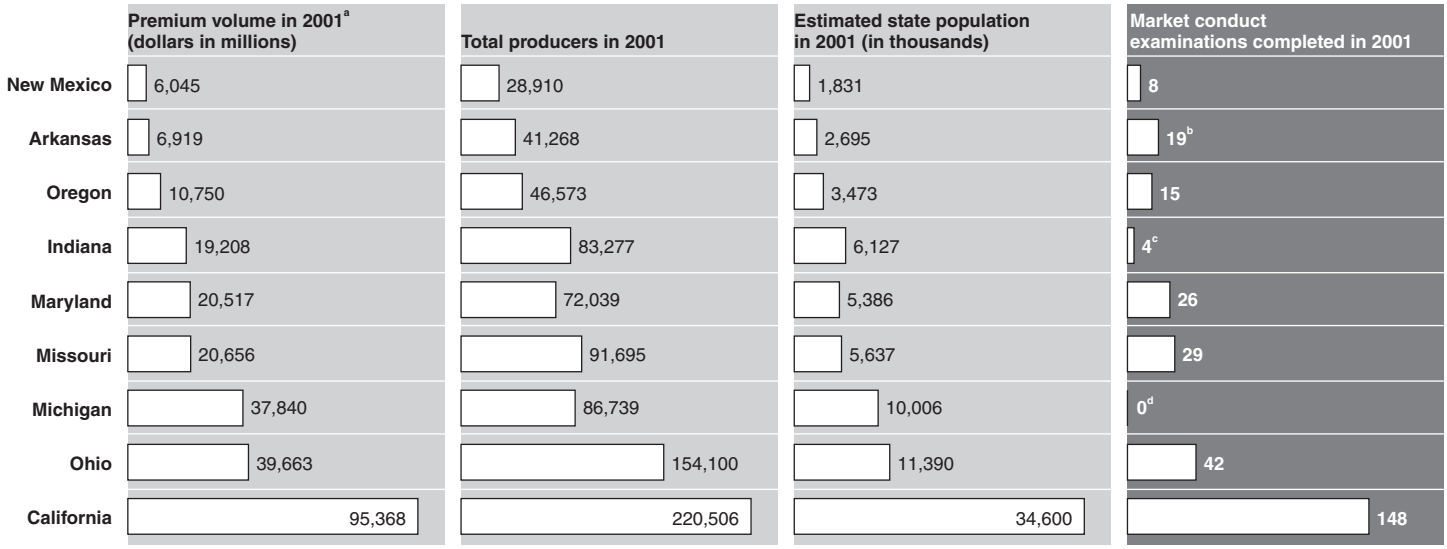
Most states also used other ways of selecting companies for examination, such as time since the last examination and market share, and the states we visited generally used some combination of factors to determine when to examine a company. For example, in Arkansas, California, Missouri, and New Mexico regulators must examine certain companies every 3–5 years, although other factors may also influence when an examination is performed. Some states may also choose companies for examination based on the companies' market share, in an effort to use limited state resources to cover the largest percentage of the state's insurance consumers. New Mexico officials also told us that they might not examine a company that they knew had recently been examined by another state.

States Did Relatively Few Examinations and Varied in the Staff Resources They Devoted to the Examination Process

As shown in table 1, each of the states we visited, with the exception of California and Ohio, did on-site examinations of less than 2 percent of the states' licensed companies in 2001. Based on the number of market conduct examinations reported by the states to NAIC, it would take many years for any of the states we visited to examine all of the companies licensed in the state—in some cases, more than 100 years. While 2001 may not have been a typical year for each state, information reported by the states to NAIC suggests that, overall, 2001 was similar to 2000. Appendix III provides state-by-state information on the number of insurers and the number of market conduct examinations completed in 2001.

As figure 1 shows, the number of examinations completed bore little relationship to the size of the insurance market in each state. This comparison should not necessarily be taken as an indicator of the relative regulatory performance of the nine states we visited because during another year the ratios could differ. However, together with the variations in the way states select companies for and conduct the examinations, this added variability helps to further explain why states may be reluctant to depend on other states' regulatory efforts.

Figure 1: Market Conduct Examinations Completed in 2001 Relative to the Size of the Insurance Market in Each State



Sources: State insurance departments, NAIC, and the U.S. Census Bureau.

Note: Does not include follow-up exams or desk audits. NAIC information taken from *2001 Insurance Department Resource Report.*

[a]Total premium volume for life, health, and property/casualty insurance.

[b]Arkansas also examined 65 funeral homes that sold prepaid funeral insurance.

[c]Three of these were multistate examinations.

[d]Michigan did a limited review of market conduct issues as part of its 37 financial examinations.

The level of staff resources states dedicated to market analysis and market conduct examinations also varied widely. In fact, NAIC's *2001 Insurance Department Resources Report* does not even break out those insurance department staff assigned to market analysis, although financial analysts are separately identified.[12] This report does give the number of market conduct examiners reported by each state. Fourteen states, or 27 percent, did not report having any market conduct examiners on staff, although 4 of the 14 did report using full-time contract examiners (see app. IV). Even subtracting these 4, 10 states, or about 20 percent, reported having no market conduct examiners at all. California had the most market conduct examiners of the states we visited (44), while Michigan had none. The number of licensed companies per examiner ranged from a low of 32 to a

[12]National Association of Insurance Commissioners, *2001 Insurance Department Resources Report* (Kansas City, Mo.: 2002).

high of 430 (excluding Michigan and Indiana). Ordinarily a team of two or more trained examiners would perform an examination.

Even though Michigan had no market conduct examiners, it did report doing 37 combined financial and market conduct examinations. Michigan regulators told us that in these examinations, examiners doing routine financial examinations on Michigan domestic companies also looked at market conduct issues. These financial examiners receive little if any training in market conduct examinations and focus primarily on financial solvency issues. One official in another state told us that he believed it was difficult for a financial examiner to do a good job in a market conduct examination because the focus of the two examination types is so different. Financial examiners are trained to verify that income and capital are at least high enough to ensure the company's solvency—that is, that expenses are relatively low and income and profits relatively high. Market conduct examiners, however, attempt to ensure that the company is treating its customers fairly. They may find that a company must pay more, pay faster, or insure people that it might rather not insure—actions that may increase costs and reduce profits. An examiner may have difficulty focusing on such diametrically opposite objectives simultaneously.

Further, no generally accepted qualifications for market conduct examiners exist. We found that states with market conduct examiners had very different requirements for qualifications and training. Although financial examiners in all states are required to have a recognized and independently certified level of expertise, only two of the states we visited—New Mexico and Oregon—required that their examiners become certified through the Insurance Regulatory Examiners Society (IRES). Despite the fact that the society offers several levels of certification for market conduct examiners, these certifications are not prerequisites to any examiner classification. In fact, NAIC's market conduct examiners handbook—which recommends the specific IRES designations examiners should obtain before they have earned one of the five examiners classifications—does not require specific training requirements or certification for the respective examiner classification.

Lack of Coordinated Oversight Burdened Some Companies and Left Others Unexamined

Many insurance companies, particularly the largest ones, have publicly stated that they were subject to frequent and sometimes simultaneous market conduct examinations. We asked 40 of the largest national insurance companies—20 life insurers and 20 property-casualty insurers—to provide information about their on-site market conduct examination experience for the years 1999–2001. (See app. I for detailed information on

our questionnaire.) Twenty-five companies responded. Of these, 19 had been examined at their offices a total of 106 times during the 3-year period. Six had been examined one or two times over the 3-year period, and 7 others had undergone 3 to 5 examinations. Thus, just over one-half of the 25 responding companies had been examined 1 to 5 times in 3 years. However, 3 companies (2 property-casualty companies and 1 life insurance company) each reported having had 15 examinations or more during the 3 years, with 1 company receiving 19 examinations—an average of over 6 a year.[13]

To some extent, these results appear to support companies' concerns about multiple, possibly duplicative, examinations. One of the most common complaints received from the 25 insurers that responded to our survey was that states did not coordinate their examinations with other states. According to the responding companies, examinations can strain company resources and result in considerable expense. One insurer wrote, "It takes an insurer a tremendous amount of effort to prepare for and deal with individual state insurance department's exams (every one is different, plus states generally do not accept others exams in place of another similar exam being done)."

Other responses to the questionnaire, however, presented another side of the picture. Six companies, or nearly one-quarter of those responding, had not been examined by any state during the period. Of these six companies, two were last examined in 1997, and the other four reported that they had no record of market conduct examinations. These companies, like all others that reported, are large, multistate insurance companies. Several of the states we visited told us that company size, or market share, was an important factor in determining which companies to examine for market conduct. This information, taken together with the relatively low numbers of market conduct examinations that states have done, suggests the possibility that many small and medium-size companies may not have been examined recently, if at all.

[13]We did not verify the companies' responses with state regulators. Moreover, we could not evaluate the basis on which the states selected specific companies to examine. That is, multiple exams may or may not be duplicative. For example, several states may examine the same company for different reasons. Alternatively, multiple state examinations of the same company may be necessitated by an insurance company's failure to take corrective action in all jurisdictions that are affected by an inappropriate activity.

The insurers responding to our survey reported that they paid an average of $115,000 for comprehensive exams and $94,000 for targeted exams. According to survey responses, the average length of time the states took to complete all on-site exams, from the date regulators first told the company that it would be examined to issuance of the final report, was 3.9 years. That is, for the insurers responding to our questions, it took an average of just over 2 years to do the fieldwork for a market conduct examination and an additional 1.8 years to finalize the report.[14] These numbers are self-reported and may not be reflective of the industry as a whole. Moreover, the time needed to complete an examination depends on many factors, such as the complexity of the issues being examined, state resources, the level of company cooperation, and the company's right to a formal administrative process. Nevertheless, some insurers responding to our questionnaire suggested that with the high cost of the examinations, the states should make greater efforts to reduce duplication.

NAIC Has Identified Market Analysis and Examinations as Areas Needing Significant Improvement

NAIC identified the need for greater uniformity in market conduct regulation as early as 1971, when it commissioned McKinsey & Company, Inc. to review the financial and market conduct surveillance activities of insurance companies. Since then, NAIC has launched a number of initiatives intended to identify and address the issues and concerns caused by the lack of uniformity in states' market conduct examinations and, more recently, in their use of market analysis. For example, in March 2003 the NAIC president announced that improving market conduct examinations and market analysis would be one of the organization's major annual goals.[15] However, despite NAIC's long-standing efforts and some successes, progress has been slow, and it remains unclear whether the quality and consistency of market conduct regulation will improve fundamentally, particularly in these two key areas. Until NAIC and the states can identify and agree on what constitutes appropriate and

[14]In congressional testimony, J. Robert Hunter, of the Consumer Federation of America, presented data showing that, on average, it took 10 years for the average state to complete any market conduct examination on a domestic insurer and longer for a nondomestic insurer. Statement of J. Robert Hunter, "Increasing The Effectiveness of State Consumer Protections," before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, May 6, 2003.

[15]NAIC's current emphasis on issues related to market conduct are in large part a response to provisions in the Gramm-Leach-Bliley Act, Pub. L. No. 06-102, November 12, 1999, which addressed insurance regulation, and to competitive pressures within the insurance industry.

consistent market regulation, significant improvement will likely be slow to arrive.

NAIC Has Long Recognized the Need to Improve Market Regulation but Has Made Slow Progress with Its Initiatives

Before the early 1970s, state insurance regulators emphasized financial solvency. However, the McKinsey study recommended establishing a separate and distinct program of market conduct surveillance, including market conduct examinations that would be separate from financial examinations and administered by different examination personnel.[16] The study also concluded, among other things, that some states had been dealing with market conduct regulatory problems for many years, but that few states had developed comprehensive, organized oversight systems that might respond to these issues. In 1974, NAIC's Market Conduct Surveillance Handbook Task Force issued a report, which recognized not only that market regulation included issues distinct from those related to financial solvency but also that market conduct examinations should be based on uniform policies and procedures. In the years since, effective progress toward this goal has been slow.

Pursuit of this goal has been primarily focused on the development of the NAIC handbook for market conduct examiners, originally adopted in 1975. As we have noted, in general, most states use the handbook as an examination guide, although they have the option of following or modifying the guidance for specific examinations. According to NAIC, the policy reason behind this voluntary use is best summarized in the following statement from the introduction to the handbook.

> The Handbook was designed as a model reflecting established practices and to assist each jurisdiction in developing its own market conduct examination procedures. The NAIC model statutes and regulations were selected as the basis for the handbook because insurance statutes in many jurisdictions have evolved from NAIC model laws. For this reason, this handbook is only a guide and should be used by each jurisdiction as a tool for developing jurisdiction specific procedures and guidelines. To effectively use this handbook, it is recommended that each jurisdiction closely review the handbook to determine those standards that reflect the statutes and regulations of the given jurisdiction and those that do not. It is recommended that each jurisdiction develop its own manual of procedures reflecting audit procedures based on the standards and methodology set forth herein and modified to meet the specific requirements of the laws of that jurisdiction.

[16]McKinsey & Company, Inc., *Strengthening the Surveillance System*, Final Report, a report commissioned by the National Association of Insurance Commissioners, April 1974.

For example, although the handbook lays out the steps for conducting an exam, such as notifying the company, using sampling techniques, and preparing an examination report, each state can go about those steps differently. Moreover, the handbook does not cover some aspects of examinations, including how often examinations should be done.

NAIC has also encouraged every state to set up a market regulation program with established minimum standards in place for necessary resources, staff, and statutes. In 1995, as part of this initiative, NAIC adopted the Market Conduct Regulatory Guidelines, which suggested procedures and services for state insurance departments to provide as part of their market regulation programs. NAIC noted that model laws and regulations, such as the Unfair Trade Practices Act and the Unfair Claims Settlement Practices Act, constitute "essential elements" of these programs, as they provide the necessary authorities for market conduct examinations. NAIC also sees adoption of these models in all states as a vital step in achieving uniform market regulation. Nearly 8 years have passed since NAIC adopted the guidelines, yet the states have been unable to reach agreement on the minimum resources and national regulatory standards necessary to achieve effective market conduct examination programs and have made even less progress in establishing those necessary for effective market analysis. However, NAIC has recently established market analysis and the creation of a market analysis handbook as a main priority.

NAIC has also created the ETS to assist in scheduling both financial and market conduct examinations. NAIC designed the system to allow examiners to communicate examination schedules and results among themselves. ETS enables states to voluntarily report all upcoming examinations so that other states can see them. Then, if another insurance department intends to examine a company that is listed on ETS, it can either wait and use the first state's results, ask to participate in the scheduled examination, or at least schedule around the first state to avoid holding a simultaneous examination at a listed company. Similarly, ETS allows regulators to post examination results so that states can use other states' results to plan their own examinations or to avoid having to do another examination at all.

While the system has been successful for financial examinations, it has not worked as well for market conduct examinations. We were told that ETS, which was originally tailored to financial examinations, was inconvenient and difficult to use for market conduct examinations. As a result, not all states have used the system, rendering it inaccurate and incomplete. NAIC

surveyed states to find out how many used the ETS and concluded that about two-thirds of the states consistently reported to NAIC on their market conduct or combined market conduct/financial examination schedules. However, we were told that few states reviewed others' planned schedules or used the information in their own planning. Moreover, only 31 percent of the states reported back to the ETS when they completed the examination process.

NAIC is currently modifying ETS to make it more user-friendly and increase the value it adds to the examination process in order to encourage more states to use it. In December 2002, the system was divided into two separate programs—financial and market conduct—to account for the differences in the examination requirements in the two areas. It is too early to determine whether these changes and others that have been proposed to make the system easier to use will increase the number of states using the ETS. According to NAIC officials, if states used the tracking system, it could help reduce duplicative exams and potentially reduce the number of unexamined companies.

In the spring of 2000, NAIC published a statement of intent that included a directive to review the current focus, structure, and implementation of market regulation programs across states and identify issues and concerns in this area. One purpose of this review was to determine the merits of voluntary uniform national standards as a basis for market conduct examinations and enforcement actions. However, NAIC officials told us that other issues in the statement of intent took priority over market conduct. As a result, from 2000 through 2002 NAIC did not focus a great deal of its attention on market regulatory reforms. Since 2002, NAIC's Market Analysis Working Group (MAWG) has been developing a draft of the *Market Analysis Handbook*. The guide is intended to provide regulators with information on how to obtain and use up-to-date data and may include a "market conduct annual statement" to help regulators identify priority issues and collect data. This market conduct annual statement could be used to provide regulators with market information analogous to the annual financial statement. NAIC believes that MAWG can become a national forum for states using the guide to share and coordinate their results. NAIC also believes that as states begin to use the annual statement, market analysis will become a more useful tool, leading to more effective market regulation. At the time of our review, development continued on the *Market Analysis Handbook* and the market conduct annual statement was being evaluated in a pilot program in nine states.

In March 2003, NAIC announced that one of its major objectives for the year was to improve market analysis and market conduct examinations. NAIC's president stated that one of the organization's primary goals was to improve the efficiency and effectiveness of market conduct efforts by making market analysis more consistent across states and expanding the number of joint examinations. Since this announcement, the attention and resources devoted to market regulation by NAIC committees and work groups have increased significantly. In testimony earlier this year, NAIC also noted that it was pursuing what it called a "central reform" that would increase awareness of the importance of market analysis as the most effective regulatory tool for targeting the most serious consumer problems.[17] NAIC stated that in spite of industry criticism that focuses on market conduct examinations, the complete package of state oversight activities must include ongoing information gathering and analysis to spot problems as early as possible and correct them:

> Market conduct exams are a useful tool, but even if sufficient resources were available to conduct more of them, such exams must be complemented by other regulatory strategies for addressing problems before they become the kind of business practice that exams typically seek to uncover.

Clearly NAIC recognizes that a combined system of market analysis and market conduct examinations is the best way to oversee the behavior of insurance companies in the marketplace. However, the development and implementation of such a combined system by NAIC and the states is still in its infancy.

Financial Regulation May Be a Model for Regulating Market Behavior

For more than 12 years NAIC has had a program that successfully demonstrates how to encourage states to adopt voluntarily standards that are consistent and binding across the states. The financial accreditation program has existed since the early 1990s, and nearly all the states now participate. During this time, the program has demonstrated its value by defining a common set of basic regulatory requirements for solvency regulation and successfully engineering their adoption by nearly all the states. Because of this program, nearly every state has increased the quantity and quality of the resources it has available for financial regulation; improved its regulatory processes; and adopted, where

[17]Statement given by Joel Ario, Insurance Administrator for the State of Oregon and Chairman of NAIC Market Regulation and Consumer Affairs Committee, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, May 6, 2003.

necessary, a consistent set of laws and regulations that are widely agreed to be necessary for effective financial regulation. Because of these improvements, most states are able to use their resources primarily for overseeing the solvency of their domiciled companies while depending on the regulation of other states for all other companies selling insurance in their states. While the quality of regulation is still not entirely consistent, the program has improved financial regulation across the states. State insurance commissioners have discussed a similar solution for problems of market regulation, perhaps adding market conduct accreditation standards to the financial accreditation program or creating a parallel program. However, to date the commissioners have not decided to pursue the issue.

While the process state insurance regulators use to oversee solvency could provide a model for overseeing market conduct as well, structural differences between financial and market regulation would undoubtedly affect the ultimate design of an improved market conduct oversight system. First, market conduct oversight involves many more and different activities and operations than financial regulation, a fact that has broad implications for regulatory consistency and mutual dependence, including requirements for training examiners and analysts. Second, regulators told us that life insurers tend to use companywide business plans and organizational structures, so that company operations tend to be relatively consistent across an entire firm. Property-casualty insurers, however, tend to use a regional business model and organizational structure, so their operations could differ across geographic areas. Clearly the life insurer model would be more directly amenable to oversight by the state in which a company is chartered than the property-casualty model, as any regional or state-by-state variances in a company's operations would reduce the effectiveness of oversight by the domiciliary state.

Third, some aspects of market conduct oversight are likely to remain state specific because of the differences among the laws and requirements of individual states. As a result, even when regulatory oversight becomes more uniform, states will probably need to continue devoting some attention to the activities of nondomestic insurers. However, knowing that other states were doing consistent market oversight on domestic companies could substantially reduce the level of attention states need to give these companies. Finally, even to the extent that properly designed and competently performed market analysis and examinations can effectively monitor and regulate insurance company practices, these tools may not be effective in identifying sales practice abuses by agents.

Conclusions

The Congress has been concerned that the current system of insurance regulation does not provide consistent consumer protection across all states and may be imposing an excessive regulatory burden on some insurers. In the absence of uniform national standards for market analysis and market conduct examinations, a patchwork of practices exists across the states. The resulting inability of state insurance regulators to depend on the oversight of other states has prevented regulatory cooperation in overseeing the market behavior of multistate insurance companies. Faced with the necessity of overseeing the market behavior of all companies selling insurance in its state, whether domiciled there or not, each insurance department has focused its scarce regulatory resources in the way that seemed most appropriate to it. As a result, regulators may examine some insurers too frequently and others infrequently or not at all.[18]

We believe that a formal market analysis program in each state and effective coordination of market conduct examinations would provide the needed basis for truly effective market regulation nationwide. Careful, thorough market analysis would provide the information needed to understand the market, monitor company behavior, and identify those companies that most need regulatory attention. Examinations coordinated among states would allow regulators to follow up on problems and issues identified through market analysis and ensure better regulatory coverage of insurance companies.[19] In addition, existing computerized audit tools could allow regulators to substantially change the way examinations are done by shifting the focus from a file review to a review of controls, systems, and processes and possibly by shortening the time needed for the examination.

But states will not have the resources to make these changes unless they are able to accept the results of regulatory actions in other states and to coordinate some activities. NAIC has been working since the 1970s to improve and increase uniformity in market regulation, but progress has been slow. We support NAIC's current goal of increasing the effectiveness of market regulation through a nationwide market analysis program. But

[18]The scope of our work did not include an analysis of whether the "right" companies were being examined or not, but no one else, including insurance regulators, knows this for sure.

[19]Officials in Missouri, which has an active formal market analysis program, emphasized this point, telling us that market analysis was not a substitute for market conduct examinations but should interact with and be integrated into the examination process.

we feel that NAIC, although recognizing market analysis as an important component of market oversight, has taken only the first tentative steps toward establishing such a program. Much work remains to be done, both on market analysis and market conduct examinations, including establishing appropriate laws, regulations, best practices, and resource requirements to support the goal of creating an effective nationwide program of market conduct regulation. However, at present it remains uncertain when—and even whether—NAIC and the states can agree on and implement a program that will accomplish this goal.

Recommendation for Executive Action

We recommend that NAIC, working with the states, give increased priority to identifying a common set of standards for a uniform market oversight program that will include all states. These standards should include procedures for conducting market analysis and coordinating market conduct examinations. Further, we recommend that a mechanism be established to encourage state legislatures and insurance departments to adopt and implement the identified minimum standards.

Agency Comments and Our Evaluation

We provided a draft of this report to NAIC and the state insurance departments that we visited— Arkansas, California, Indiana, Maryland, Michigan, Missouri, New Mexico, Ohio, and Oregon. NAIC and six of the states provided us with technical corrections to the report, which have been included as appropriate. We asked the states to forward any comments they had regarding the report message or policy issues to NAIC for inclusion in NAIC's response. NAIC's comment letter is reproduced in appendix V.

NAIC told us that, overall, the report confirmed several concerns that state regulators and the insurance industry share about market regulation and, particularly, about market analysis and market conduct examinations. While NAIC recognized that our report focused on market analysis and market conduct examinations, it reiterated that market regulation extends beyond these two functions and is different than financial solvency regulation. Moreover, it is more difficult to harmonize than financial regulation. For example, the market behaviors of insurers can be quite different from one state to another, both because the laws may be different and because insurer compliance with the laws may vary by state. NAIC's detailed comments on our report primarily focus on the following three areas and its efforts to address these areas: (1) market analysis, (2) uniform examination procedures, and (3) collaborative regulatory efforts.

NAIC stated that it is aware of the varying approaches to market analysis across the states and that it has made the creation of a more systematic and structured market analysis system among the states a top priority. NAIC identified two avenues through which it is pursuing improved and more consistent market analysis—the development of a market analysis handbook and the implementation of a market conduct annual statement pilot program. We support NAIC's current goal of increasing the effectiveness of market regulation through a nationwide market analysis program. However, we feel that NAIC, although it recognizes market analysis as an important component of market oversight, has taken only the first tentative steps toward establishing such a program. Much work remains to be done, both on market analysis and market conduct examinations, including establishing appropriate laws, regulations, best practices, and resource requirements to support the goal of creating an effective nationwide program of market conduct regulation.

NAIC noted that in 2002 it adopted the Market Conduct Uniform Examination Outline to help minimize variations in market conduct examinations so that states can rely more on each other's examination findings. This outline focuses on four areas of the examination process—(1) exam scheduling, (2) pre-exam planning, (3) core examination procedures, and (4) examination reports. NAIC's goal is to have at least 40 states certify compliance with all four areas of examination uniformity and to develop a process for resolving complaints about certifications. We support NAIC's efforts to increase uniformity in the examination process. However, while useful, the elements of the Market Conduct Uniform Examination Outline address only some of the issues keeping states from relying on other states' examinations. For example, as we discuss in the report, states that do market conduct examinations tend to severely limit the scope of their examinations. Moreover, one state may not have known whether another state would commit sufficient resources to a market conduct examination or require appropriate examiner expertise since there are no generally accepted standards. The lack of common standards for market analysis and for some areas of examinations and inconsistency in applying the guidelines that do exist for examinations make reciprocity among states difficult and reduce willingness to accept other states' examination results.

NAIC agreed with our report that more collaborative efforts should be initiated to eliminate the potential duplication of regulatory efforts. At the same time, NAIC pointed out that not every case of multiple examinations is duplicative. NAIC noted that multiple examinations would not be duplicative if the states were examining the same company for different

reasons. Moreover, the states' ability to eliminate duplicative efforts is sometimes hindered by the insurance companies' failure to take corrective action in all jurisdictions that are affected by an inappropriate activity. We recognize in the report that all cases of multiple examinations reported in response to our questionnaire may not have been duplicative because we could not evaluate the basis on which the states selected specific companies to examine. Among other efforts to reduce inappropriate duplication of examinations, NAIC specifically mentions the enhancements to the ETS that we discuss in the report and stated that as of March 2003, 26 states had entered information on examination schedules for 400 companies. As our report indicates, however, to be truly useful, all states need to be using the ETS for entering information on their scheduled and completed examinations and for checking other states' entered information.

NAIC also reports on other efforts it is pursuing to increase the number of collaborative examinations being held. Finally, NAIC suggests that in a state-based system, in which different laws exist in each state to protect consumers, the extent to which a state can rely on another state's market conduct examinations is inherently limited. It points out that, as government officials, state regulators cannot delegate to someone else, even another state, the responsibility of enforcing their states' laws. This statement is, true, however, we were told both by state regulators and industry representatives that there are significant areas of market regulation that are similar across the states. Moreover, state regulators and state legislators should be working together to increase the consistency of state consumer protections and other laws and regulations related to market conduct of insurance companies. Thus duplication of effort can be avoided if market analysis and examination standards and processes are improved, adopted, and implemented across the states. We also note that in addition to apparent duplication of market conduct examinations for some companies, other responses to our questionnaire indicated that other companies had infrequent market conduct examinations or none at all. Improved consistency of laws, regulations, analysis, and examination processes accompanied by better coordination among the states could also allow those companies to receive better oversight.

Finally, as shown both in NAIC's comments and in our report, NAIC is undertaking a number of initiatives intended to improve both market analysis and market conduct examinations. The goal is worthwhile. However, it should be noted that NAIC's activity is only the first of the steps needed to make real improvements in market analysis and market conduct examinations. The models developed by NAIC must then be

adopted and implemented by the states, either by regulation or by legislation when needed.

We will send copies of this report to the Ranking Minority Member of the House Committee on Financial Services and other interested congressional committees. We will also send copies of this report to the Executive Vice President of NAIC and to the 55 state and other governmental entities that are members of NAIC and will also make copies available to other interested parties upon request. This report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions on this report, please contact me on (202) 512-8678. An additional contact and other contributors are listed in appendix VI.

Sincerely yours,

Richard J. Hillman
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to (1) evaluate the use of market analysis and on-site examinations in market regulation and (2) discuss the progress of the National Association of Insurance Commissioners (NAIC) to improve and coordinate market regulation at the state level.

To address our first objective, we visited and interviewed officials from nine states' insurance departments—Arkansas, California, Indiana, Maryland, Michigan, Ohio, Oregon, Missouri, and New Mexico—and from NAIC's Kansas City headquarters. We also reviewed these states' operating procedures for market regulation and interviewed staff from each of the states' units responsible for the types of market regulation conducted by the state.

To determine the use of market analysis and on-site examinations in market regulation, we interviewed state officials responsible for these activities. We also collected and analyzed data relating to the number of licensed companies in each state, the number and types of examinations conducted, and the resources allocated to these activities.

We designed and administered a questionnaire to obtain the perspectives of life and property/casualty insurance companies on the extent and cost of market conduct examinations. The questionnaire sought information about the frequency and type of market conduct examinations that were completed from January 1, 1999, through December 31, 2001. For each exam reported, companies were asked to provide specific information about the exam, including the state that performed the exam; exam costs and location; and notification, fieldwork, and final report dates. The questionnaires administered to the life and property/casualty companies were identical with the exception of a set of items related to securities industry examinations of life insurance companies.

We obtained the 2002 lists of the top 200 life and property/casualty insurers from NAIC. For the purpose of this work, NAIC was deemed the most accurate data source since insurers are required to regularly report to it updated financial and other company-related information. Using the NAIC rankings, a judgmental sample of 40 companies was selected. We selected a random group of life and property/casualty companies that are licensed and do business in all 50 states within several groups defined by size and region. Size was measured according to total assets for life companies and total premiums for property/casualty firms. Ten of the larger and 10 of the smaller companies from our list of the 200 largest companies were selected. To determine region, the companies were

allocated across four geographical categories defined by the U.S. Census Bureau.

The small, nonprobability sample prevents inferences to the population of life and property/casualty insurers but still allows some documentation of the extent of duplication among the selected firms. Because this judgmental sample was not intended to be statistically representative of the population of insurers, our results were not weighted to adjust for the different probabilities of selection of each insurer we selected.

The selected insurers submitted their completed surveys through electronic mail or facsimile. Responses were received from 25 (62 percent) of the companies. The collection of insurer survey data began in October 2002 and was completed in January 2003.

As a part of the survey design process, we also conducted survey pretests. The companies selected to participate reflected the kinds of companies we were interested in surveying, specifically in terms of company size and the number of states in which a firm were licensed and did business. Each pretest participant was sent a copy of the instrument and given several days to return its completed survey to us. We instructed each participant to route the survey to the best contact—the person most knowledgeable about market conduct exams at the company. We also scheduled time to discuss with each company contact the basis of the company's response to each survey item.

To determine the effectiveness of NAIC's efforts to improve the market regulation program, we interviewed officials from NAIC, attended its national meetings to identify current market regulation issues, reviewed its past market regulation issues, and reviewed its past and current initiatives to improve the market regulation program.

Appendix II: Market Conduct Exams Completed in 2001

State/territory	Combined financial and market conduct exams		Market conduct exams only		Total exams
	Routine	Targeted	Routine	Targeted	
Alabama	10	5	0	2	**17**
Alaska	0	0	0	0	**0**
American Samoa	N/A	N/A	N/A	N/A	**N/A**
Arizona	0	0	0	131	**131**
Arkansas	16	2	0	0	**18**
California	0	0	N/A	N/A	**148**[a]
Colorado	0	0	0	24	**24**
Connecticut	0	0	39	2	**41**
Delaware	27	0	0	3	**30**
District of Columbia	0	0	0	0	**0**
Florida	0	0	10	86	**96**
Georgia	0	0	17	8	**25**
Guam	N/A	N/A	N/A	N/A	**N/A**
Hawaii	0	0	3	0	**3**
Idaho	6	0	0	1	**7**
Illinois	0	0	8	19	**27**
Indiana	0	0	0	3	**3**
Iowa	9	0	24	0	**33**
Kansas	0	0	1	0	**1**
Kentucky	0	0	8	2	**10**
Louisiana	30	1	2	30	**63**
Maine	0	0	0	2	**2**
Maryland	0	0	10	42	**52**
Massachusetts	0	0	0	61	**61**
Michigan	34	2	0	0	**36**
Minnesota	4	0	0	0	**4**
Mississippi	13	1	0	4	**18**
Missouri	0	0	41	7	**48**
Montana	0	0	0	0	**0**
Nebraska	0	0	10	23	**33**
Nevada	2	0	9	8	**19**
New Hampshire	0	0	0	12	**12**
New Jersey	0	0	10	1	**11**
New Mexico	6	0	0	2	**8**

State/territory	Combined financial and market conduct exams		Market conduct exams only		Total exams
	Routine	Targeted	Routine	Targeted	
New York	62	1	4	92	**159**
North Carolina	0	0	22	17	**39**
North Dakota	0	0	1	1	**2**
Ohio	0	0	0	38	**38**
Oklahoma	17	2	9	9	**37**
Oregon	0	0	11	4	**15**
Pennsylvania	0	0	21	1	**22**
Puerto Rico	N/A	N/A	N/A	N/A	**N/A**
Rhode Island	0	0	6	0	**6**
South Carolina	7	1	1	8	**17**
South Dakota	0	0	0	3	**3**
Tennessee	26	0	0	0	**26**
Texas	142	2	0	5	**149**
U.S. Virgin Islands	N/A	N/A	N/A	N/A	**N/A**
Utah	5	0	2	5	**12**
Vermont	0	0	3	1	**4**
Virginia	0	0	19	39	**58**
Washington	0	0	5	9	**14**
West Virginia	3	0	0	0	**3**
Wisconsin	0	2	0	14	**16**
Wyoming	1	0	0	0	**1**
Total	**420**	**19**	**296**	**719**	**1,454**

Source: NAIC 2001 Insurance Department Resources Report, tables 22 and 23.

Legend: N/A – Not available

Note: The number of exams may not equal the totals in table 1. The data in table 1 were obtained directly from the states and have not been reconciled with data reported by the states to NAIC.

[a]NAIC reported that the breakout of the 148 market conduct exams completed in California in 2001 was not available.

Appendix III: Number of Licensed Insurers and Total Market Conduct Examinations in 2001

State/territory	Licensed domestic insurers	Licensed foreign insurers	Total licensed insurers	Total market conduct examinations
Alabama	53	1,277	**1,330**	17
Alaska	8	1,063	**1,071**	0
American Samoa	0	22	**22**	N/A
Arizona	398	1,525	**1,923**	131
Arkansas	74	1,464	**1,538**	18
California	219	1,210	**1,429**	148
Colorado	74	1,410	**1,484**	24
Connecticut	132	1,055	**1,187**	41
Delaware	144	1,426	**1,570**	30
District of Columbia	23	1,347	**1,370**	0
Florida	201	1,612	**1,813**	96
Georgia	106	1,473	**1,579**	25
Guam	5	151	**156**	N/A
Hawaii	117	926	**1,043**	3
Idaho	23	1,426	**1,449**	1
Illinois	446	1,469	**1,915**	27
Indiana	183	1,598	**1,781**	3
Iowa	220	1,403	**1,623**	33
Kansas	57	1,642	**1,699**	1
Kentucky	52	1,504	**1,556**	10
Louisiana	147	1,485	**1,632**	64
Maine	33	925	**958**	2
Maryland	96	1,392	**1,488**	52
Massachusetts	94	1,273	**1,367**	61
Michigan	142	1,383	**1,525**	36
Minnesota	94	1,438	**1,532**	4
Mississippi	70	1,428	**1,498**	18
Missouri	247	1,411	**1,658**	48
Montana	28	1,407	**1,435**	0
Nebraska	113	1,440	**1,553**	33
Nevada	39	1,704	**1,743**	19
New Hampshire	49	859	**908**	12
New Jersey	101	1,165	**1,266**	11
New Mexico	19	1,476	**1,495**	8
New York	505	927	**1,432**	159

State/territory	Licensed domestic insurers	Licensed foreign insurers	Total licensed insurers	Total market conduct examinations
North Carolina	97	1,243	**1,340**	39
North Dakota	42	1,378	**1,420**	2
Ohio	275	1,505	**1,780**	38
Oklahoma	104	1,480	**1,584**	37
Oregon	139	1,486	**1,625**	15
Pennsylvania	313	1,404	**1,717**	22
Puerto Rico	38	275	**313**	N/A
Rhode Island	33	1,210	**1,243**	6
South Carolina	50	1,424	**1,474**	17
South Dakota	52	1,403	**1,455**	3
Tennessee	111	1,559	**1,670**	26
Texas	512	1,529	**2,041**	149
U.S. Virgin Islands	2	195	**197**	N/A
Utah	45	1,423	**1,468**	12
Vermont	410	937	**1,345**	4
Virginia	82	1,407	**1,489**	58
Washington	69	1,336	**1,405**	14
West Virginia	20	1,304	**1,324**	3
Wisconsin	355	1,536	**1,891**	16
Wyoming	4	1,304	**1,308**	1
Total	**7,065**	**-**	**-**	**1,454**

Source: NAIC 2001 Insurance Department Resources Report, tables 17, 22, and 23.

Legend: N/A – Not available

Notes: Includes combination financial/market conduct exams and market conduct exams only (see app. II). The number of exams and insurers may not equal the totals in table 1. The data in table 1 were obtained directly from the states and have not been reconciled with data reported by the states to NAIC.

Appendix IV: Number of Market Conduct Examiners and Total Licensed Insurers in 2001

State/territory	Total number of market conduct examiners	Total number of licensed insurers
Alabama	2	1,330
Alaska	3	1,071
American Samoa	N/A	22
Arizona	0	1,923
Arkansas	2	1,538
California	29	1,429
Colorado	8	1,484
Connecticut	7	1,187
Delaware	0	1,570
District of Columbia	3	1,370
Florida	14	1,813
Georgia	1	1,579
Guam	N/A	156
Hawaii	0	1,043
Idaho	0	1,449
Illinois	19	1,915
Indiana	1	1,781
Iowa	4	1,623
Kansas	2	1,699
Kentucky	0	1,556
Louisiana	3	1,632
Maine	2	958
Maryland	10	1,488
Massachusetts	4	1,367
Michigan	0	1,525
Minnesota	0	1,532
Mississippi	0	1,498
Missouri	33	1,658
Montana	0	1,435
Nebraska	5	1,553
Nevada	1	1,743
New Hampshire	3	908
New Jersey	15	1,266
New Mexico	0	1,495
New York	92	1,432

State/territory	Total number of market conduct examiners	Total number of licensed insurers
North Carolina	11	1,340
North Dakota	1	1,420
Ohio	12	1,780
Oklahoma	0	1,584
Oregon	3	1,625
Pennsylvania	11	1,717
Puerto Rico	N/A	313
Rhode Island	4	1,243
South Carolina	3	1,474
South Dakota	0	1,455
Tennessee	0	1,670
Texas	5	2,041
U.S. Virgin Islands	N/A	197
Utah	7	1,468
Vermont	1	1,347
Virginia	18	1,489
Washington	5	1,405
West Virginia	2	1,324
Wisconsin	7	1,891
Wyoming	0	1,308
Total	**353**	-

Source: NAIC 2001 Insurance Department Resources Report, tables 3 and 17.

Legend: N/A – Not available

Notes: Full-time equivalent staffing. Includes domestic and foreign insurers. The number of market conduct examiners and insurers may not equal the totals in table 1. The data in table 1 were obtained from the states and have not been reconciled with data reported by the states to NAIC.

Appendix V: Comments from the National Association of Insurance Commissioners

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

EXECUTIVE HEADQUARTERS
2301 McGee Street
Suite 800
Kansas City MO
64108-2662
voice 816-842-3600
fax 816-783-8175

FEDERAL AND INTERNATIONAL RELATIONS
Hall of the States
444 North Capitol St NW
Suite 701
Washington DC
20001-1509
voice 202-624-7790
fax 202-624-8579

SECURITIES VALUATION OFFICE
1411 Broadway
9th Floor
New York NY
10018-3402
voice 212-398-9000
fax 212-382-4207

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September 9, 2003

Richard J. Hillman
Director, Financial Markets and Community Investment
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the proposed report, *Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation*. Overall, the report confirmed several concerns that state regulators and the insurance industry share about market regulation and, particularly, market analysis and market conduct examinations.

The NAIC would like to offer several comments and suggestions to clarify certain statements in the report and update the GAO on the current NAIC's market regulatory reforms.

If you have any questions regarding the suggestions to the report or should you need additional information please do not hesitate to contact us or, in our absence, Tim Mullen at 816-783-8260.

Sincerely,

Joel Ario
Oregon Administrator of Insurance
Chair of the NAIC's Market Regulation & Consumer Affairs (D) Committee

Catherine J. Weatherford
NAIC Executive Vice President & CEO

SEPTEMBER 9, 2003

NAIC COMMENTS ON THE GAO'S PROPOSED REPORT

INSURANCE REGULATION: COMMON STADARDS AND IMPROVED COORDINATION NEEDED TO STRENGTHEN MAREKT REGULATION

Overall, the report confirms several concerns that state regulators and the insurance industry share about market regulation and, particularly, market analysis and market conduct examinations. While the NAIC recognizes the report focuses on market analysis and market conduct examinations, the NAIC reminds the GAO that market regulation extends beyond these two functions.

The NAIC also reminds the GAO that market regulation is different than financial solvency regulation and is more difficult to harmonize than financial regulation. The market behaviors of insurers can be quite different from one state to another, both because the laws may be different and because insurer compliance with the laws may vary by state.

To parallel the broad concepts addressed in the report, the NAIC's comments primarily focus on the following three areas and the NAIC's efforts to address these areas: (1) market analysis, (2) uniform examination procedures and (3) collaborative regulatory efforts. In the relatively short period of time since this study was initiated, the states have made tremendous progress in their efforts to develop common standards for market analysis, more uniformity in market conduct examinations and greater collaboration in examination efforts.

Finally, the comments provide additional detail on the NAIC's perspective regarding specific statements in the report.

Market Regulation

While the NAIC recognizes the report focuses on market analysis and market conduct examinations, it is important to recognize that market regulation consists of all of the following components even if they are not always defined and organized as separate activities: (1) consumer complaint handling, (2) producer licensing, (3) rate and form review, (4) market analysis, (5) market conduct examinations, (6) investigations and (7) enforcement. In addition, state insurance departments typically include various other ancillary activities, such as consumer education and outreach, especially to vulnerable populations, oversight of residual markets and antifraud programs. Because of this broader scope, one must consider the effectiveness and efficiencies of all of these activities to fully understand how insurance regulators monitor companies' market behaviors.

1

Market Analysis

The GAO report indicates that few states conduct routine and systematic market analysis. The NAIC is aware of the varying approaches to market analysis and has made the creation of a more systematic and structured market analysis system among the states a top priority. As part of the NAIC's efforts, the NAIC is developing a market analysis handbook and implementing a market conduct annual statement pilot program to determine if such an annual statement could be used by all states.

The purpose of the market analysis handbook is to identify data and other information that is available to regulators and provide guidance on how that data can be used to target the most significant market problems. In addition to helping identify potential problems, the handbook will help states develop a more detailed understanding of the marketplace and target their regulatory resources more efficiently. If used consistently and uniformly by the states, the handbook also should facilitate interstate collaboration by giving states a common baseline of knowledge from which to pursue collaborative actions.

In 2002, the NAIC completed Phase I of the market analysis handbook, compiling a broad range of potential data resources that might be used for market analysis. During 2003, the NAIC is completing Phase II of the market analysis guide, which focuses on how states can use three key data sources to target the most significant market problems: (1) complaint data, (2) relevant financial data and (3) market share information.

The market conduct annual statement is a pilot project designed to determine whether a market conduct annual statement could serve as a market analysis tool that all states could use to review market activity of the entire insurance marketplace in a consistent manner and to identify companies whose practices are outside normal ranges. If the pilot is a success, this will be a tool to help states more effectively target market regulatory efforts. By using common data and analysis, states would have a uniform method of comparing companies' performance not only within their respective states but also across the various states, providing enhanced opportunities for coordinating market regulatory efforts. This increased analysis, targeting and coordination should result in fewer duplicative regulatory efforts. As the statement develops, states should be able to reduce the number of state-specific data calls and collect data about claims, non-renewals and cancellations, replacement-related activity and complaints on an industry-wide basis.

In the pilot, information is being collected for personal lines, life and annuity products. If a company's performance appears to be unusual as compared to the industry, states will undertake further review of that company. The additional review may range from calling the company for further information to pursuing further analysis or conducting an examination.

In 2002, the nine pilot states (CA, IL, MD, MO, NE, OH, OR, PA and WI) began collecting data from life insurers. The life data has now been received and analyzed. Based upon this analysis, specific companies have been identified for additional scrutiny and an appropriate regulatory response.

2

The pilot states also are working with P&C insurers. P&C insurers are required to submit data for the period of January 1, 2003 through June 30, 2003 by Sept. 1, 2003. Assuming there are no data quality issues, the pilot states will complete their analysis of the data by November 1, 2003. During the NAIC 2003 Winter National Meeting, the pilot states will discuss their results for the property and casualty industry, identify common companies of concern and propose coordinated responses where appropriate.

Uniform Examination Procedures

The GAO report indicates that states vary in their approach to market conduct exams. To help minimize variations in market conduct examinations so that states can rely more on each other's findings, the NAIC adopted the *Market Conduct Uniform Examination Outline*. This outline, which was developed in 2002, focuses on the following four areas: (1) exam scheduling, (2) pre-exam planning, (3) core examination procedures and (4) exam reports. Greater uniformity in exam scheduling will enhance the states' ability to coordinate their exam scheduling in ways that minimize duplication and encourage states to cooperate more. Greater uniformity in pre-exam planning will enhance the states' ability to better target problem areas and provide companies with a clearer understanding of what is expected of them. The development of uniform examination procedures will make the exam process more predictable and improve exam consistency across states. Finally, greater uniformity in exam reports will allow all audiences, from examiners to consumers, to better understand and compare exam results.

Forty of the fifty-five jurisdictions self-certified compliance with two of the four uniform examination areas in 2002. The goal for 2003 is to have at least 40 states certify compliance with all four areas of exam uniformity and develop a process for resolving complaints about certifications. This project also includes implementation of more detailed uniformity standards in key areas, such as use of the Exam Tracking System (ETS) and standardized data calls.

Collaborative Regulatory Efforts

The GAO report indicates the lack of coordinated oversight burdened some companies and left others unexamined. The NAIC agrees that more collaborative efforts should be initiated to eliminate the potential duplication of regulatory efforts. At the same time, the NAIC questions whether the states' scopes of examination were similar. There would be no duplication of effort if the states were examining the same company for different reasons. Another common issue that hinders the states' ability to eliminate duplicative efforts is the insurance companies' failure to take corrective action in all jurisdictions that are impacted by an inappropriate activity.

To help facilitate the coordination of regulatory efforts, the NAIC's Exam Tracking System (ETS) was enhanced in 2002 to make the reporting and sharing of market conduct examination information easier. As of March of 2003, 26 states had entered examination information on over 400 companies into ETS. The NAIC has been analyzing this

information to identify multiple exam notifications for the same companies. At the 2003 NAIC Summer National Meeting, the NAIC staff shared the list of companies with multiple examinations scheduled and the states shared their respective exam plans and concerns about the identified companies. Where overlap was noted, a lead state was designated to coordinate efforts. Since then, regulators have continued to discuss common concerns and to coordinate their efforts. With the increased use of ETS and regular opportunities for states to share information, improved coordination of exam efforts is well underway.

Forty states are currently participating or have participated in at least one new collaborative market conduct examination during 2003. Based upon these collaborative efforts, the NAIC's Market Analysis Working Group is now developing formalized guidelines and protocols for the collaboration of regulatory efforts.

As noted above, the NAIC has been looking carefully at the extent to which one state can rely on the findings of another state when it comes to making regulatory decisions about examinations, investigations and enforcement actions. The NAIC is looking at collaborative models for relying on the domestic state (or some combination of states) for baseline monitoring of companies and has several specific collaborative projects underway. But, ultimately, the NAIC cannot escape the fact that regulatory violations can affect consumers in different states quite differently. Since regulators are government officials who must enforce the laws of their state, they cannot delegate that responsibility to someone who may not understand or appreciate the nature of a particular violation and its impact on local consumers.

The NAIC, therefore, believes it is critical to first recognize the primacy of state consumer protection laws when attempting to increase regulatory coordination. For example, an important complement to states relying on each other for baseline monitoring of companies is the flexibility for states to conduct targeted examinations, investigations, and enforcement actions when there is a specific consumer problem requiring attention. If the NAIC does not build in adequate flexibility for a state to protect its citizens under the laws of that state, the NAIC would be asking state regulators to ignore their oath of office. In effect, the NAIC would be creating a system that would not work and would not have the confidence of the consumers and government officials it is intended to serve.

For example, New York faces unique market problems regarding the price, availability, and administration of terrorism insurance. The Superintendent of Insurance in New York has devoted much effort to making the terrorism insurance market work for consumers in his state. Would New York feel comfortable being forced to accept the findings of another state dealing in a generic way with terrorism exclusions when the problems in New York are unique to the terrorism risks confronting the New York market? Would another state regulator where the insurer is domiciled really understand the vagaries of the New York market or the nuances of New York law?

Likewise, regulators in Florida and other coastal states will have a special interest in underwriting practices and policy terms for insurance covering hurricane damages. State regulators also will have different views of health underwriting practices based on the dynamics in their local markets. Congress recognized this when it imposed minimum portability requirements on the states, but allowed states to preserve current laws or develop new ones that were tailored to local conditions, as long as the minimum standards were met.

The NAIC and its members have the expertise to handle the tensions between promoting uniform market conduct oversight across the United States while preserving local control over matters that directly affect consumers and policyholders within each state. The NAIC believes much progress can be made to achieve the goals of efficiency sought by industry representatives. However, the NAIC does not overlook the fact that insurance must be regulated to protect local consumers. Regulatory efficiency for its own sake should not undermine the credibility and effectiveness of the state regulators charged with enforcing consumer protection laws.

NAIC's Perspective Regarding Specific Statements in the Report

Having addressed the three broad issues of market analysis, uniform examination procedures and collaborative regulatory efforts, the NAIC would like to provide additional comments on specific statements in the report.

NAIC's Information Sharing Tools

While the report addresses the ETS, the report does not recognize the following NAIC market information systems: (1) the Complaint Database System (CDS), (2) the Regulatory Information Retrieval System (RIRS), (3) the State Licensing Producer Database (SLPDB) and (4) the Special Activities Database (SAD). The NAIC recommends that these systems be mentioned and defined in the report.

See comment 1.

- Complaints Database System (CDS): CDS has been operational since 1991 and is only available to regulators. Complaint information is recorded to identify the type, reason, and ultimate disposition of complaints. Reports readily provide the number of complaints and are useful for analyzing trends related to complaints for an individual or company. As a compliment to the regulator only CDS, the NAIC developed the Consumer Information Source (CIS). The CIS provides aggregate complaint data to the public in a consumer friendly format.

- Regulatory Information Retrieval System (RIRS): RIRS has been operational as an electronic database since 1985 with information available to both regulators and the public. This system tracks adjudicated regulatory actions for companies, producers, and agencies. The origin, reason, and disposition of the regulatory action are recorded.

5

- State Licensing Producer Database (SLPDB): SLPDB contains license information relating to insurance producers and brokers. Data concerning disciplinary history, administrative actions, licensure status (resident and non-resident), and appointments are maintained. This database also features automatic alerts to regulators when a producer's license is suspended or revoked.

- Special Activities Database (SAD): SAD is available to regulators only and has been operational since 1989. This system records information regarding suspicious or investigative activities related to individuals and companies in the insurance industry.

Exam Criteria

See comment 2.

While the report states there are no generally accepted criteria for determining which companies to examine, the NAIC's *Market Conduct Examiners Handbook* and the NAIC's *Market Conduct Uniform Examination Outline* set forth specific criteria for calling a market conduct examination. These criteria include the following: (1) statutory examination requirements, (2) internal complaint analysis, (3) compliance with statutes and regulations, including producer licensing, (4) rate and form review, (5) market share analysis, (6) exam findings from previous market conduct exams, (7) information from the commissioner of another jurisdiction, (8) reports and analysis from the NAIC's market information systems, (9) financial analysis and IRIS ratios, (10) information from other external sources, (11) changes in control environment, (12) pre-admission, (13) market conduct annual statement and (14) findings from previous financial examinations. In addition to these criteria, states communicate about market regulatory issues and identify companies for potential examinations through chief examiners forums, which are held during each NAIC national meeting.

Findings of PricewaterhouseCoopers

See comment 3.

The NAIC takes exception to the findings of the PricewaterhouseCoopers study that concluded comprehensive examinations tend to look for isolated mistakes and errors. The NAIC's *Market Conduct Examiners Handbook* provides the following guidance regarding examinations: "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."

As reflected in the NAIC's handbook, insurance regulators are looking for business practices that are in violation of the insurance laws and not isolated errors. A random sample of files is reviewed for compliance with the insurance laws. Although individual errors within the sample are noted, errors on individual files are not held against the company unless they occur with such frequency as to be considered a business practice. The NAIC's handbook provides guidance on sampling techniques and recommended error rates. For example, on non-claim files, the desired compliance rate is 90%, meaning that 10 out of 100 files might contain errors and the company would pass the test. The company would fail the test only if the error occurred in more than 10% of the

files, i.e. with such frequency that it could be considered a business practice and not an isolated or inadvertent error. The NAIC recommends the report be changed to reflect the sampling techniques used in market conduct exams and the focus on business practices.

Table 1: Market Conduct Examinations and Licensed Insurers in 2001

See comment 4.

While Table 1 is footnoted that it does not include desk audits and follow up examinations, the NAIC believes this table skews the effectiveness of state market regulation. If this table is used, the NAIC believes it would be more accurate to clarify that state efforts to monitor the marketplace fall within a broad continuum of regulatory options and that states initiate on-site examinations only when less intrusive means of regulatory intervention will not work.

Time Frame to Complete Examinations

See comment 5.

The NAIC questions the findings of the company survey and the report of J. Robert Hunter. While the report notes the findings are based upon company responses to a survey, the report does not reference the potential of company response bias, which may create inaccurate results. In addition, the NAIC questions the resources relied upon by J. Robert Hunter and the validity of his analysis in reaching his conclusion. If such figures are retained in the report, the report should recognize that the time needed to complete an examination is dependent upon many factors, such as the complexity of the issues being examined, state resources, the level of company cooperation and the company's right to a formal administrative process.

Voluntary Use of the NAIC's *Market Conduct Examiners Handbook*

See comment 6.

Because the reference to the voluntary use of the handbook in the report reflects a negative connotation and does not recognize how the handbook was developed or varying state laws, the NAIC believes the policy reason behind this voluntary use should be included in the report. The handbook was designed as a model reflecting established practices and to assist each jurisdiction in developing its own market conduct examination procedures. The NAIC model statutes and regulations were selected as the basis for the handbook because insurance statutes in many jurisdictions have evolved from NAIC model laws. For this reason, this handbook is only a guide and should be used by each jurisdiction as a tool for developing jurisdiction specific procedures and guidelines. To effectively use this handbook, it is recommended that each jurisdiction closely review the handbook to determine those standards that reflect the statutes and regulations of the given jurisdiction and those that do not. It is recommended that each jurisdiction develop its own manual of procedures reflecting audit procedures based on the standards and methodology set forth in the handbook and modified to meet the specific requirements of the laws of the jurisdiction.

G:data\misc\GAOcomment

7

The following are GAO's comments on NAIC's letter dated September 9, 2003.

GAO Comments

1. We recognize NAIC's role in providing data services to the states and we have acknowledged and discussed the databases mentioned by NAIC in previous reports.[1] However, a discussion of all the databases mentioned by NAIC would have been outside the scope of this report, which was directly concerned with the existing market conduct analysis and examination practices of the states.

2. The report states, "there are no generally accepted criteria for determining which companies to examine"(page 3). We believe this to be a true statement. Each of the state insurance departments that we visited had its own criteria for determining when to do an examination and they often varied substantially from state to state. While NAIC provided a list of 14 factors from the *Market Conduct Examiners Handbook* that states may consider when prioritizing companies for examinations, these factors do not, in our opinion, constitute "generally accepted criteria." A criterion that was generally accepted would be always or usually applied consistently and predictably. We did not find this to be true in our review of states' practices.

3. We modified the report to more clearly state PricewaterhouseCoopers' finding that "market conduct examiners *sometimes* tend to look for isolated mistakes and errors…" (Emphasis added) (page 13). We also added a footnote noting the guidance provided in the *Market Conduct Examiners Handbook* on looking for general business practices when conducting an examination.

4. A note was added to table 1 which more clearly explaining that we have classified desk audits and other off-site reviews of company files as part of market analysis rather than as market conduct examinations, even though we recognize their importance to many states, including Ohio.

5. On page 18 we added to the report the language suggested by NAIC.

[1]U.S. General Accounting Office, *Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight*, GAO/GGD-00-198 (Washington D.C.: Sept 19, 2000), *Financial Services Regulators: Better Information Sharing Could Reduce Fraud*, GAO-01-478T (Washington D.C.: Mar. 6, 2001), and *Regulatory Initiatives of the National Association of Insurance Commissioners*, GAO-01-885R (Washington D.C.: July 6, 2001).

6. We added NAIC's reference from the introduction of the *Market Conduct Examiners Handbook* to the report in its entirety (see page 20).

Appendix VI: GAO Contacts and Staff Acknowledgments

GAO Contacts

Richard J. Hillman, (202) 512-8678
Lawrence D. Cluff, (202) 512-8678

Acknowledgments

In addition to the persons named above, contributors to this report were Monty Kincaid, Thomas H. Givens, Carl Ramirez, Kevin Jackson, Bonita Vines, and Emily R. Chalmers.

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