

United States General Accounting Office
Washington, DC 20548

July 6, 2001

The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

Subject: Regulatory Initiatives of the National Association of Insurance
Commissioners

Dear Mr. Dingell:

As you requested, this report provides information on selected initiatives undertaken by the National Association of Insurance Commissioners (NAIC) to improve state insurance regulatory processes. NAIC developed these initiatives in response to provisions in the 1999 Gramm-Leach-Bliley Act (GLBA), Public Law 106-102, which mandated changes in insurance regulation, and to competitive pressures within the insurance industry. Our study was prompted by your concern that some of the initiatives may adversely affect regulators' ability to conduct proper solvency oversight of insurers, particularly in light of the regulatory weaknesses identified after the recent insurance investment scam allegedly perpetrated by Martin Frankel.¹

The specific objective of this report is to describe the current status of six NAIC initiatives intended to comply with provisions of GLBA and improve competitiveness in the financial services sector. Additionally, we will describe the status of actions that NAIC and some states have taken in response to recommendations contained in our September 2000 report. Throughout this report, we will also highlight challenges and areas that merit continued attention in NAIC's efforts to improve regulatory processes in the insurance industry.

Results in Brief

NAIC has undertaken an ambitious agenda of initiatives intended to streamline and promote uniformity at the state level. Under pressure from GLBA and insurance industry participants that are faced with increasing competition from firms in the banking and securities industries, NAIC and state regulators are working to implement these initiatives. For example, NAIC and the states are developing streamlined licensing systems that will allow agents and brokers to conduct business in more than one state after satisfying the licensing requirements administered by a single state. Another streamlining initiative seeks to develop a more uniform and efficient approach for

¹We recently issued a report to you on this matter that included proposed corrective actions designed to shore up regulatory deficiencies revealed during the scam. See *Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight* (GAO/GGD-00-198, Sept. 19, 2000).

bringing new products to market. Success in implementing these initiatives depends largely on the extent to which states “buy in” to the concepts of uniformity and reciprocity as these concepts apply to state insurance regulation. If these initiatives are to succeed, states will need to be more willing than they have been in the past to accept the regulatory due diligence and licensing decisions of another state. The more uniform regulatory processes and functions are across states, the easier it will be to gain such acceptance. At the same time, insurance regulators are being challenged to avoid “watering down” regulatory standards in order to achieve uniformity, but, rather, to follow best practices and the standards of “leading” states to enhance insurance regulation across all of the states. Once NAIC members agree on recommendations that would create more uniform regulatory statutes, two additional challenges remain. First, state legislatures must approve the recommendations without significant changes. Second, each state insurance department must successfully implement the recommendations. At present, both the timely completion and ultimate success of NAIC’s initiatives remain uncertain.

NAIC and several states have also initiated a series of corrective actions that address recommendations made in our report on the recent scandal. NAIC’s corrective actions, which are to be phased in over several years, include improvements in the following areas: background checks on industry applicants, investment analyses and asset verifications of insurers’ portfolios, regulatory coordination and communication among regulators, and accreditation requirements for state insurance departments. For instance, NAIC is working to implement a process for conducting routine criminal and regulatory history checks on potential new entrants to the industry. Collectively, these actions have the potential to improve oversight if NAIC and the states sustain a high-level commitment to implementing them.

Background

Insurance companies are regulated by the states, unlike the banking and securities industries, which are under a dual federal-state oversight system, with federal regulators taking a leading role. NAIC is a voluntary association made up of the heads of each insurance department from the 50 states, the District of Columbia, and 4 U.S. territories. NAIC assists the states in their regulatory responsibilities with guidance, model and recommended laws and regulations, and information-sharing tools. NAIC does not have regulatory authority over the state insurance departments but provides a national forum for addressing and resolving issues affecting the insurance industry and, in certain instances, for promoting consistency in regulatory policies. As part of its national accreditation program, NAIC reviews the regulatory activities of state insurance departments that relate to assessing the financial solvency of insurers.

Recent federal legislative changes and trends in financial modernization within the industry have had a significant impact on insurance regulation, particularly with the enactment of GLBA. GLBA requires state insurance regulators to implement certain reforms or face losing their exclusive authority over some regulatory functions. Specifically, the act calls for the states to establish a uniform or reciprocal licensing system for agents and brokers within 3 years of its enactment. If the majority of states do not establish this system, a new regulatory board, the National Association of Registered Agents and Brokers (NARAB), will be created. Any state licensed insurance producer

whose license has not been suspended or revoked would be eligible to join NARAB.² Membership in the association would entitle the member to licensure in each state where the member pays the requisite fees, including licensing fees, and, where applicable, satisfies bonding requirements set by each state. NAIC and the state insurance commissioners (or chief regulatory officials) will determine whether the states have met GLBA's requirements for a reciprocal or uniform licensing system.

In an effort to avoid the establishment of NARAB, NAIC and the states are working to meet GLBA's requirements within the 3-year period. In March 2000, NAIC endorsed the *Statement of Intent: The Future of Insurance Regulation*, which lays out its vision of the regulatory improvements needed to implement the GLBA provisions and respond to changes within the financial services sector. This document describes NAIC's goals—uniformity, efficiency, and modernization—for regulation of the insurance industry. NAIC's current financial modernization initiatives can be traced back to this document.

Insurance industry participants have also advocated regulatory reforms, some of which go beyond GLBA's requirements. For instance, some industry representatives have advocated creating a federal regulator for insurance and giving companies the choice of either state or federal regulation. A number of the initiatives prescribed in the *Statement of Intent* were developed in part to counter industry pressures for an optional federal charter.

A recent insurance scam also highlighted areas where insurance regulation could be improved (see figure 1). GAO and the Tennessee State Auditor both reported similar regulatory oversight weaknesses tied to an insurance investment scam allegedly perpetrated by Martin Frankel.³ The State Auditor concluded that the Tennessee Department of Commerce and Insurance had failed to detect the fraudulent nature of Frankel's alleged activities before May 1999 because regulators failed to exercise sufficient professional skepticism, used inadequate procedures, and misapplied review procedures. The state auditors also cited a lack of communication between the Insurance Division staff and other department officials (the state's Securities Division is part of the Department of Commerce and Insurance). Similarly, we observed weaknesses in insurance oversight by several states where insurance companies were victimized by the scam. Among these weaknesses were inadequate regulatory tools, policies, and procedures; a lack of communication between regulators within and outside of the insurance industry; and inadequate professional skepticism about numerous "red flags" during nearly 8 years of the scam.

²According to GLBA, the purpose of NARAB shall be to (1) provide a mechanism through which uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements and conditions can be adopted and applied on a multistate basis, while preserving the right of states to license, supervise, and discipline insurance producers and (2) prescribe and enforce laws and regulations with regard to insurance-related consumer protection and unfair trade practice.

³*Special Report: Review of Inaction on the Part of Insurance Division Employees Involved in the Regulation of Franklin American Life Insurance Company*, Tennessee Comptroller of the Treasury (July 7, 2000).

Figure 1: Recent Insurance Scam Focuses on Insurer's Investment Activities

The recent insurance investment scam allegedly perpetrated by Martin Frankel was tied to the investment activities of a number of multistate insurers. Throughout the 1990s, Martin Frankel, with assistance from others, allegedly obtained secret control of entities in both the insurance and securities industries. He reportedly anonymously acquired and controlled insurance companies in several states and, despite being barred from the securities industry, secretly exercised control over a small securities firm. Using the name of this securities firm, Frankel allegedly took custody of insurance company assets and provided false documents on investment activities to disguise his actual purpose. Instead of managing the assets prudently, he purportedly diverted nearly \$200 million to other accounts he controlled and used the funds to support the ongoing scam (and his lifestyle). The scam was finally exposed after insurance regulators in Mississippi took enforcement action against three insurers connected to the scam, placing them under regulatory supervision. Frankel currently faces criminal and civil actions in connection with his alleged involvement in the scam.

In response to the regulatory weaknesses uncovered as a result of the investment scam, NAIC and some states have initiated corrective actions to help prevent such a fraud from occurring again. In April 2000, NAIC issued its final report recommending both short- and long-term corrective actions to address regulatory weaknesses associated with the scam. (The final report and recommendations were included in our September 2000 report.) Additionally, some of the states most affected by the scam have indicated that they also plan to take, or have taken, corrective actions.

Scope and Methodology

To identify the status of NAIC initiatives, we reviewed NAIC's organizational structure and agenda. In particular, we obtained information on NAIC's efforts to assess and implement provisions of GLBA and promote regulatory modernization. We focused on six initiatives:

- **Producer Licensing Reciprocity and Uniformity:** Provides for developing a streamlined system and uniform standards for licensing agents and brokers in more than one state, thereby avoiding the federal creation of NARAB, an entity that could license agents and brokers on a multistate basis.
- **Speed to Market:** Facilitates the accelerated approval of products to be marketed in more than one state.
- **National Treatment of Companies:** Develops a more efficient system of licensing multistate insurers.
- **Coordinating With Federal Regulators:** Promotes coordination between state insurance departments and federal financial regulators.
- **Insurance Holding Company:** Develops appropriate oversight procedures for financial holding companies with insurance affiliates (formerly known as Financial Services Holding Company Analysis/Examination/Review).

- **Market Conduct:** Evaluates and harmonizes safeguards to protect insurance consumers against inappropriate sales practices.

To summarize the status of each initiative, we provided available information on the problem or issue that each initiative was designed to address, information on what has happened to date, and future plans. In some cases, this included NAIC's summary of legislative actions taken by states, because we did not perform an independent review of individual state laws.

NAIC and the states have identified a number of corrective actions needed to address regulatory deficiencies highlighted by the investment scam allegedly perpetrated by Mr. Frankel. To describe the progress made to date, we obtained information from NAIC on their short- and long-term actions to address issues related to the fraud. Additionally, we solicited information on corrective actions undertaken in states victimized by the scam, particularly in Tennessee and Mississippi. (Tennessee was home to the headquarters of seven insurers connected with the fraud, three of which were domiciled in Mississippi.)

We did our work between November 2000 and June 2001 in accordance with generally accepted government auditing standards.

NAIC's Financial Modernization Initiatives Aim to Produce More Streamlined and Uniform State Regulatory Processes

Many of NAIC's initiatives are interrelated, focusing on promoting faster regulatory approvals for agents, brokers, products, and companies. Table 1 summarizes the status of each of these initiatives, while enclosures I through VI describe them in greater detail. NAIC and the states are working to develop a model licensing process that would permit insurance agents and brokers to meet licensing requirements in all states by satisfying the licensing requirements of any one state. A similar process would apply to products being approved for marketing in more than one state. Other initiatives include improving communication and coordination with other financial services regulators and strengthening consumer protection oversight. At present, both the timely completion and ultimate success of these initiatives remain uncertain.

Table 1: Summary of Selected NAIC Initiatives

NAIC initiative	Purpose and description	Status and timetable for completion
Producer Licensing Reciprocity and Uniformity	To develop a licensing system based on uniform state licensing laws and reciprocity practices in order to promote greater efficiency in licensing insurance agents and brokers.	Under GLBA, a majority of states (at least 29 separate jurisdictions) must meet certain uniformity or reciprocity requirements in the 3-year period ending in November 2002 to avoid the creation of NARAB. According to NAIC, 33 states have passed agent licensing laws, which NAIC is reviewing for NARAB compliance. NAIC's goal is for all states to become NARAB compliant by November 2002 and, ultimately, achieve uniform producer licensing laws in all states.
Speed to Market	To develop a more uniform, streamlined approach to new product filing and review processes.	A limited launch began in May 2001. A subgroup of this initiative—the Coordinated Advertising, Rate, and Form Review Authority (CARFRA)—is conducting the limited launch, which involves 4 types of life and health products in 10 states. After testing in the launch states, NAIC expects the new product approval process to be fully implemented within a year after the launch for certain types of insurance products.
National Treatment of Companies	To standardize the company licensing review process for multistate insurers and to bring about greater coordination and communication of regulatory filings associated with mergers and acquisitions involving an insurance company.	Efforts to create a more centralized licensing and oversight review process were abandoned by NAIC in favor of improvements to existing licensing processes, including the use of a common, uniform licensing form, the Uniform Certificate of Authority Application (UCAA). As of July 3, 2001, 46 states and the District of Columbia were using UCAA. By July 31, 2001, NAIC expects all states will be using UCAA.
Coordinating With Federal Regulators	To establish a more efficient state regulatory system that fully implements GLBA, eliminates unnecessary duplication, and takes advantage of new technologies to facilitate the communication and coordination between state and federal regulators.	In March 2000, NAIC developed a model information-sharing agreement with the Office of Thrift Supervision (OTS). In December 2000, NAIC approved model regulatory cooperation agreements with the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). In March 2001, NAIC reported that individual states were in the process of signing agreements with federal bank regulatory agencies and developing cross-training and educational sessions with insurance and banking regulators. As of June 27, 2001, 45 states had signed bilateral agreements with OTS, 13 with OCC, 14 with FDIC, and 4 with the Federal Reserve.
Insurance Holding Company (formerly Financial Services Holding Company Analysis/ Examination/Review)	To assess the implications of GLBA on NAIC's existing model laws and regulations concerning holding companies in general, and to develop best practices for reviewing holding companies.	The focus of this initiative has shifted from oversight of new financial holding companies, as defined by GLBA, to improving the oversight of holding companies in general. On November 10, 2000, NAIC introduced a draft document, <i>Framework for Insurance Holding Company Regulation</i> , for review and comment. Having undergone extensive review to date, a final report is planned for issuance at the 2001 Winter National Meeting. Additionally, recommended amendments to existing NAIC model laws are expected to be adopted by NAIC at the 2001 Fall National Meeting.
Market Conduct	To protect consumers from abuses in the insurance market, including those related to the availability and affordability of insurance, by reviewing the underwriting and marketing practices of insurers and producers.	In 2001, a working group will collect and analyze data, prioritize key issues for examination, and assess interstate cooperation in developing guidelines for market conduct. A progress report and recommendations will be presented at the 2001 Winter National Meeting.

Source: GAO summary of NAIC material.

NAIC and the States Have Made Some Progress Toward Streamlining and Creating Uniformity in Licensing and Approval Processes

Three of NAIC's initiatives focus on streamlining licensing or approval functions—Producer Licensing Reciprocity and Uniformity, Speed to Market, and National Treatment of Companies. Success in implementing these initiatives hinges largely on regulators' willingness to accept more regulatory uniformity, reciprocity, or both. As discussed in figure 2, the notion of reciprocity, which requires states to accept the regulatory standards of other states when making licensing decisions, is linked to uniformity. The greater the degree of uniformity that exists among the states, the easier it will be to achieve reciprocity.

Figure 2: Uniformity and Reciprocity Under GLBA

GLBA set out criteria that a majority of the states must meet in order to avoid the creation of NARAB. These criteria can be satisfied in either of two ways—that is, through uniformity or reciprocity.

- To satisfy the uniformity criterion, the states must agree to modify their individual laws, regulations, and processes so that the requirements for licensing agents are uniform across states. Agents and brokers would still need to apply for a license in each state where they intend to do business. With uniform requirements, however, getting a nonresident license would be nearly automatic.
- To satisfy only the reciprocity criterion, the states would not need uniform laws. Instead, each state would have to agree to issue a nonresident license to agents licensed in another state **without additional requirements** in order to be in compliance with GLBA's NARAB reciprocity requirements. In this case, a reciprocity-compliant state issuing a nonresident license would be accepting the licensing requirements of that agent's state—irrespective of their differences.

Meeting either of these standards presents its own set of difficulties. To achieve uniformity, it may be difficult for state regulators to agree on the appropriate set of uniform rules and then convince a majority of the state legislatures to adopt them without changes. With reciprocity, states would not have to change their laws, regulations, and processes but might have difficulty convincing a particular state insurance department to give nonresidents from states with fewer requirements the same rights as its own resident agents to sell insurance in the state.

NAIC and state insurance departments have made progress in developing more streamlined and uniform agent and broker licensing processes. Although the exact timetable for completing the minimum requirement for this initiative—that is, for having a majority of states certified by NAIC as being “NARAB compliant”—is still uncertain, NAIC believes that a majority of states have likely adopted the necessary changes already. NAIC and state regulators have a stated goal of achieving uniformity in this initiative and moving toward uniformity in other areas of regulation. Nevertheless, as a matter of practical strategy, state insurance regulators have decided to focus on satisfying the GLBA provisions for reciprocity rather than attempting to achieve uniformity within the time constraints imposed by the law. State regulators feel it will be easier to get states to

agree to accept another state's rules as a basis for approving a nonresident license than to agree to and adopt a set of uniform laws, regulations, and procedures by November 2002. However, some challenges still exist. For example, one issue is how to handle differences in state requirements concerning the nature and extent of background checks conducted on agents applying for a license. Discussions at recent NAIC national meetings have focused on whether states could comply with GLBA reciprocity requirements while still requiring nonresident agents to comply with some additional requirements.

At its 2001 Spring National Meeting in March, NAIC reported that nine states had enacted producer licensing laws to satisfy NARAB reciprocity requirements. NAIC had previously developed the Producer Licensing Model Act⁴ to help states formulate new agent licensing legislation. From March through June, another 24 states also passed laws related to agent licensing. NAIC, however, still has to review these laws (including those in the original nine states) to ensure that the new laws comply with the GLBA requirements.

Other NAIC initiatives are also aimed at streamlining regulatory processes. For instance, some life insurance companies maintain that they cannot compete effectively with other noninsurance financial institutions because of the inefficient product approval process in the current state insurance regulatory environment. NAIC is trying to respond to these concerns by streamlining regulatory processes in order to bring products into the marketplace more quickly. The Speed to Market initiative aims to expedite approval of some types of new insurance products by using a centralized point of filing, the Coordinated Advertising, Rate, and Form Review Authority (CARFRA). With this process, CARFRA would first review products against a set of criteria agreed to by all the states and then against any additional criteria set by individual states. Once CARFRA has completed its review, it would issue state-by-state recommendations for approving the product. State regulators would retain their authority to grant approval for the product in their own states. If they agree to participate in CARFRA, however, they would generally be expected to follow the review team's recommendations. NAIC officials told us that a test launch of the CARFRA process is currently underway.

The National Treatment of Companies initiative is also aimed at streamlining regulatory approval processes, this time for insurers conducting business in more than one state. Initially, a "national treatment system" was being considered under this initiative that would have created a unified national system operated by state insurance regulators for the licensing, solvency oversight, and market conduct regulation of large, multistate companies. NAIC and the states have since abandoned this approach, choosing instead to focus their efforts on state-by-state practices to increase efficiency and consistency in licensing, corporate governance, and the regulation and review process for chartering or change-in-ownership applications. NAIC and state insurance regulators are also working to develop an automated uniform application, the Uniform Certificate of Authority Application (UCAA), which would facilitate the licensing approval process by requiring companies to fill out only one application form. Insurers would still need to be licensed in each state where they intended to do business, but UCAA would eliminate the need to file multiple applications with different information. NAIC expects that all states will be using UCAA by July 31, 2001.

⁴This model act creates standards for key areas of producer licensing, such as standards for license denials, and exempts licensed producers who apply for a nonresident license from completing prelicensing requirements and examinations. The model act also establishes a system of producer licensing reciprocity among the states.

Other Initiatives Stress Coordination and Consumer Protection

Two other NAIC initiatives—Coordinating with Federal Regulators and Insurance Holding Company—emphasize the need for uniformity and coordination among regulators, including those overseeing the banking and securities industries, as the financial landscape changes as a result of GLBA. NAIC is seeking to expand communication among regulators by helping state authorities establish bilateral agreements with federal regulatory agencies, including the Federal Reserve Board, the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). While many of these treaties or agreements have been adopted, the process is still in its early stages. Meanwhile, unresolved issues remain. For instance, federal and state regulators will have to develop procedures for dividing assets among affiliated entities of a failed financial holding company. NAIC believes the agreements being reached will create a framework for communicating and resolving issues of common concern to state and federal regulators.

The Insurance Holding Company initiative also grew out of GLBA.⁵ However, this initiative has evolved to focus more broadly on traditional insurance holding companies as well. Regulators working on the renamed Insurance Holding Company initiative are developing a document entitled *Framework for Insurance Holding Company Regulation*. This document is intended to provide guidance and best practices for state insurance regulators in supervising insurance holding companies and their affiliates. NAIC believes that this focus on improving regulatory practices for existing insurance holding companies will be applicable to insurance affiliates of holding companies in general, including newly formed financial holding companies, as defined by GLBA.

Finally, the Market Conduct initiative is intended to promote best practices and uniform regulatory standards in order to enhance consumer protection. This initiative addresses oversight issues related to the conduct of agents, brokers, and companies in the marketplace. Currently, NAIC's accreditation program does not review state mechanisms for overseeing market conduct. The initiative is still at the data-gathering stage where information is being collected to assess abuses of market conduct and problem areas for consumers.

Market conduct includes all issues related to the sale of insurance products to consumers, including sales practices and "suitability"—that is, the agent's responsibility to ensure that a product meets a customer's needs, particularly products marketed to elderly citizens. Market conduct is not an initiative that comes directly out of either GLBA or insurance industry pressures to relieve the regulatory burden on the insurance industry. However, this initiative is related to efforts to streamline and accelerate the process for getting new products to market. In many states the extensive and time consuming product approval process, together with a mechanism for resolving consumer complaints, have served as tools for protecting consumers of insurance. Many industry

⁵GLBA created a new entity known as the financial holding company (FHC). GLBA permits consolidation among banks, securities firms, and insurance companies. FHCs may engage in a list of financial activities, including banking, securities, insurance underwriting, merchant banking, and other activities the Federal Reserve Board determines to be financial in nature. Although the Federal Reserve Board provides umbrella oversight of FHCs, GLBA establishes functional regulation, with state insurance regulators supervising insurance activities; the Securities and Exchange Commission (SEC) regulating securities activities; and federal and state banking agencies continuing to oversee banking activities.

participants, consumer advocates, and regulators believe that improved market conduct oversight, while important in its own right, becomes even more crucial if NAIC succeeds in its efforts to streamline and abbreviate product approval processes.

State regulators' efforts to modernize and streamline insurance regulation rests on two pillars—strengthening the internal processes within each state and developing uniformity across states, particularly in areas of regulation that deal with multistate insurers. This process faces many challenges. Of particular importance is the challenge of raising the overall quality of insurance regulation by adopting uniform expectations, standards, and models that represent “best practices” for each aspect of insurance regulation. The alternative—negotiating a uniform standard that represents something less than the best practice—would weaken the quality of insurance regulation, with potentially serious consequences for both solvency and consumer protection.

Numerous Corrective Actions Related to Frankel's Alleged Scam Have Been Initiated

In the aftermath of a scam allegedly carried out by Martin Frankel involving several insurers during the 1990s, NAIC proposed numerous corrective actions to address regulatory weaknesses highlighted by the scam. These corrective actions are in various stages of completion, though most have yet to be fully implemented. In addition, some affected states have initiated their own corrective actions to improve regulatory oversight as a result of the scam.

In April 2000, NAIC's Ad Hoc Task Force on Solvency and Anti-Fraud proposed a list of near- and long-term corrective actions to insurance regulatory processes. These actions included improvements to NAIC's *Financial Analysis Handbook* and *Financial Condition Examiners Handbook*, most focusing on assessing an insurer's investment activities. Additionally, this task force identified needed improvements to NAIC's accreditation program. These accreditation program improvements included identifying the appropriate custodial requirements for insurer assets, using investment specialists on certain examinations, implementing more proactive communications between states, and establishing a “Form A Database” to help states track the status of change-in-ownership applications being submitted to other state regulators. To date, NAIC reports that considerable activity has occurred regarding the near-term (Level I) corrective actions. While some activity has occurred in the areas of longer term corrective actions (Levels II and III), most of those actions have yet to be completed. Further details on the reported status of NAIC corrective actions can be found in enclosure VII.

In addition to the corrective actions undertaken by NAIC as a result of the investment scam allegedly perpetrated by Mr. Frankel, some states have also initiated corrective actions. In particular, regulators in Tennessee, Mississippi, and Missouri have identified corrective actions they are taking to prevent a similar investment scam from occurring again.

The Tennessee Department of Commerce and Insurance has implemented several improvements to strengthen its oversight of insurance companies. According to the Tennessee Insurance Division, it has made several improvements in the areas of investment confirmation, documentation and communication, analysis, and fraud detection. These improvements include obtaining written confirmation of assets from independent third-party sources, maintaining more complete records of communications with insurance companies, intensifying scrutiny of annual and quarterly financial reviews

by an analyst's supervisor, and training staff to recognize fraud indicators. Tennessee has also reorganized certain state-level activities to help promote better communications between insurance and securities regulators.

Officials in the Mississippi Insurance Department told us that they have instituted a number of corrective actions emanating from lessons they learned from the scam as well as NAIC suggestions and our recommendations. These actions involve enhancing financial examination procedures as well as increasing the insurance department's staffing levels. Mississippi also indicated it had adopted NAIC's updated *Financial Analysis Handbook* as the standard for use by its financial analysts.

In September 2000, the Missouri Department of Insurance reported several regulatory corrective actions as a result of this investment scam. These corrective actions included adopting legislation to better safeguard and verify assets of an insurer held by custodians, expanding efforts to share with and retrieve information from other regulatory authorities, and increasing staff training and tools to analyze securities and investment strategies.

Conclusions

NAIC's efforts to promote sound and uniform regulatory processes across the states are being put to the test as pressure builds from both GLBA and competitive forces for more efficient and streamlined insurance regulatory processes. One factor affecting the ultimate success of these efforts is the level of confidence state regulators will have in their counterparts' willingness and ability to adequately obtain, assess, and validate information provided by industry applicants in making regulatory decisions. Each state will be required to rely on the actions of regulators in other states to a greater degree than ever before. Whether regulators ultimately achieve uniformity in some areas or even attain reciprocity, continuing weakness in some states' regulatory framework can undermine the system.

NAIC and state regulators believe that the development of more uniform and streamlined methods for obtaining licensing approval on individuals, products, and insurance companies in multiple states can enhance the ability of insurers to compete with other financial services entities while at the same time maintaining or improving the quality of insurance regulation. At present, both the timely completion and degree of success for many of NAIC's financial modernization initiatives remain uncertain.

NAIC is making progress toward implementing corrective actions for weaknesses identified by the scam allegedly perpetrated by Mr. Frankel, although much remains to be done. As NAIC and state regulators work to complete both financial modernization initiatives and actions to correct known regulatory deficiencies, recognition of the importance of consistency between the two efforts becomes increasingly apparent. Since many of NAIC's initiatives and corrective actions are interrelated, the states and NAIC have the opportunity to "raise the bar" for insurance regulation across the states generally by incorporating corrective actions and best regulatory practices into more streamlined, uniform processes for all states.

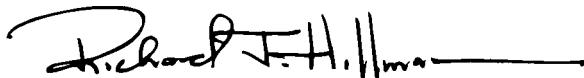
Agency Comments

We requested comments on a draft of this correspondence from NAIC. We received general comments and technical suggestions on the draft correspondence from the Executive Vice President of NAIC. NAIC responded that they generally concurred with our results and conclusions. Where appropriate, we also incorporated technical suggestions made by NAIC on the draft correspondence. In its response NAIC emphasized its desire to enhance communications and information sharing with all functional regulators, especially in the area of access to criminal background information. NAIC officials also noted that regulatory information sharing could be facilitated with federal legislation allowing for and protecting the confidentiality of information shared between federal agencies, state regulators and NAIC.

As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this correspondence until 30 days from its issuance date. At that time, we will send copies of this report to the Chairman of the Committee on Energy and Commerce as well as the Chairman and Ranking Minority Member of the Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs. We will also send copies to the President and other officials of the NAIC. At that time, we will also make copies available to other interested parties.

Please contact me or Lawrence D. Cluff at (202) 512-8678 if you or your staff have any questions about this report. Major contributors to this report were Jim Black, Thomas Givens, Shirley Jones, Barry Kirby, and LaSonya Roberts.

Sincerely,

A handwritten signature in black ink, reading "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman
Director, Financial Markets and
Community Investment

Producer Licensing Reciprocity and Uniformity Initiative

One of the most important functions of state insurance regulators is the licensing of agents and brokers. These individuals provide the link between the insurance company covering the risk and the customer buying the insurance. Traditionally, each state has set its own licensing requirements, so that agents and brokers operating in more than one state must apply for a number of licenses. Generally, this procedure has meant submitting the same information each time—or worse, different information, depending on the state’s requirements. This inefficient system led the Congress to include a provision in the Gramm-Leach-Bliley Act (GLBA) requiring state insurance regulators to either create a system that would eliminate the costs and inefficiencies associated with multistate licensing or face the federal creation of the National Association of Registered Agents and Brokers (NARAB) to facilitate such licensing. GLBA sets a 3-year time frame for establishing the state-based system and the adoption of it by a majority of states.⁶

GLBA encourages the states to establish a uniform system that makes licensing requirements for agents and brokers the same across all of the states. But GLBA also offers states the option of creating reciprocal agreements under which states would grant nonresident licenses to agents licensed in other states. In other words, the reciprocity conditions of GLBA would be satisfied if a majority of the states agreed to accept the licensing requirements of other states, even if those requirements differed from their own.

The National Association of Insurance Commissioners (NAIC) and state insurance regulators have chosen to work toward satisfying the reciprocity requirement first, although they have said that their ultimate goal is uniformity. In January 2000, NAIC adopted the Producer Licensing Model Act, which is designed to create uniformity in state licensing procedures, simplify the licensing process, promote the use of NAIC licensing-related databases, eliminate retaliatory fees, define allowable exceptions to the rules, and mandate reciprocity across states.

To help implement a more uniform, streamlined licensing process, NAIC has also formed an organization known as the National Insurance Producer Registry (NIPR), a public-private partnership of NAIC and industry representatives.⁷ NIPR has developed and implemented the Producer Database (PDB) and the Producer Information Network (PIN). (A more detailed description of these information systems resources is shown in table 2.)

⁶According to NAIC officials, 29 states would satisfy the NARAB provisions of GLBA that refer to a “majority of the States,” because sec. 336(4) of GLBA defines the term “State” to include “any State, the District of Columbia, any territory of the U.S., Puerto Rico, Guam, American Samoa, the Trust Territory of the Pacific Islands, the Virgin Islands, and the Northern Mariana Islands.” NAIC officials identified 57 jurisdictions counted for reciprocity or uniformity purposes with the simple majority being 29.

⁷NIPR was incorporated in October 1996 and is a nonprofit affiliate of NAIC. NIPR is governed by a board of directors, on which five members represent NAIC and four a cross section of the insurance industry.

Table 2: NAIC Information System Resources Supporting Uniform Licensing

Type of information system	Description of system
Producer Database (PDB)	PDB is an electronic database of information relating to insurance agents and brokers. Designed to assist insurers and regulators in monitoring for fraud, PDB is linked to participating state licensing systems and provides them with data on 2.6 million of the nation's 3 million agents and brokers. PDB also includes data from the Regulatory Information Retrieval System (RIRS), a nationwide database of insurance regulatory actions.
Producer Information Network (PIN)	PIN is an electronic communication network that links state insurance regulators with the entities they regulate. PIN facilitates the electronic exchange of producer appointments, terminations, fees, and applications. According to NAIC, 35 states are currently using PIN, which generated 1.2 million transactions in 2000. NIPR plans to use PIN to facilitate the electronic processing of nonresident license applications.

In March 2001, NAIC announced that nine states had passed producer licensing laws attempting to satisfy GLBA's NARAB reciprocity requirements. As of June, NAIC reported that 24 additional states had also passed producer licensing legislation. However, NAIC officials acknowledged that they still needed to conduct a review of these laws (including those in the original nine states) to assess whether they comply with the GLBA requirements. Furthermore, NAIC acknowledges that there is still ongoing discussion over the interpretation of GLBA's reciprocity provisions. In order to meet the deadline set in GLBA, at least 29 states must satisfy the requirements by November 12, 2002. NAIC's goal is to have at least a majority of the states achieve reciprocity by November 12, 2002. At the same time, NAIC plans to have all 50 states using the PIN and contributing to the PDB in 2001.

Speed to Market Initiative

Traditionally, insurers obtain approval from the state regulatory authority before introducing a new or modified product to the market. Since most insurance products are sold in a number of states, insurers have been faced with applying for approval numerous times. For consumer products, approval has nearly always included a review of the policy's language—that is, the explanation of what the policy does and does not cover—and the rate, or price, of the product. Insurers have said that this process can take several months, during which time they cannot market the new product. In spite of the delays and inefficiencies, insurers have said that they did not generally view the problem as significant as long as their primary competitors—other insurance companies—all faced similar costs. However, with the increasing convergence of financial industries, insurers, particularly life insurers, now also compete with securities firms and banks for the savings dollars of consumers. Neither securities firms nor banks have a regulatory process for product approval that is comparable to that faced by life insurers. As a result, some insurers believe they are at a competitive disadvantage in bringing new products to market, and they are interested in the possibility of creating a “federal charter” or license that could give one-stop regulatory approval to new products that could then be marketed in any state.

In order to forestall pressures from the industry to create a federal insurance regulator, state regulators, working through NAIC, have committed themselves to streamlining the product approval process. This effort, called “Speed to Market,” is intended to reduce the time and expense of having a new product approved in more than one state by creating more efficient, uniform standards for reviewing and approving new insurance products at both the state and national levels.⁸ Specifically, the initiative aims to

- create a system that will allow for complete reviews of product rates, contracts, and advertising within 30 days;
- develop a one-stop system of submitting information for products issued in more than one state, with deference to the state where the insurer is located; and
- evaluate the feasibility of developing an electronic repository for filing and tracking data.

State insurance regulators acknowledge that national standards may not be appropriate for all insurance products. In addition, since the system will be voluntary, some insurers may elect not to submit their products for national review. For these reasons, the initiative focuses on both national- and state-level standards. The new standards will integrate procedures for licensing a product in more than one state with the regulatory requirements of individual states.

Licensing a Product in More Than One State

NAIC's Coordinated Advertising, Rate, and Form Review Authority (CARFRA) is developing the one-stop filing proposal and intends to make recommendations to the member regulators that will make the final decision on the new system. CARFRA membership is open to the chief insurance regulators of every state and territory and the District of Columbia. The CARFRA board—elected by the members—would be responsible for determining which products are eligible for review and which standards should be applied, subject to ratification by members. The board would also set up an appeals committee to hear objections to a decision on a product. Under the proposal, insurers with new products that are intended for sale in more than one state

⁸ States typically require insurance companies to submit information on new products, including how much the products will cost, how the contracts will be written, and what kind of advertising will be used.

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could opt to enter the CARFRA review process. A team would then review the product, using standards developed by CARFRA and approved by members. After a CARFRA review and recommendation, each participating state would be expected to approve the product for sale in its state.

NAIC expects that CARFRA review standards for eligible products will be accepted by all participating states. However, some states may still have certain requirements that are not generally agreed to by other states. These differences or “variances” are to be included in the CARFRA process. However, all variances are to be identified and published before a state begins participating in CARFRA. Then, after a CARFRA team reviews a newly submitted product for conformance with the general standards, the product would be reviewed against the variances for those states in which it is expected to be sold. Both reviews are to be completed within 30 days. The CARFRA team would then make a recommendation to each applicable state for or against approval. While each state has the option to either accept or reject the recommendation or, indeed, to review the product independently, NAIC expects that a participating state will generally accept a CARFRA team’s recommendations.

A limited launch of the CARFRA system, involving 4 types of life and health insurance products, began on May 1, 2001, in 10 states (together, these states account for 35 percent of total national premiums).⁹ The limited launch is expected to last only 8 to 12 months. Another 5 to 10 states and additional products will be added later in 2001, and NAIC projects the CARFRA approval process to be fully implemented within a year after the launch.

Improving State-Based Review and Approval Systems

NAIC does not expect all insurance products to be appropriate for CARFRA review. Moreover, insurers have the option not to use the national review system for product approval, even for included products. Nevertheless, NAIC believes that the state-based review and approval process for these products can also be improved. The initiative to improve state-based review and approval systems addresses internal state processes for product approval. The initiative aims to enhance state rate (price), form (policy language), and advertising review units by reforming and standardizing their approval processes. An important reform component is the implementation of the System for Electronic Rate and Form Filing (SERFF) in all states. SERFF, a centralized electronic filing repository, also provides many of the functions needed to support the CARFRA initiative. Thus, it is an integral part of efforts to create a uniform, streamlined product review system at both the national and state levels.

Under the state-based initiative, states are urged to

- review standards checklists to provide clear guidance on state requirements,
- establish a 30-day review and compliance time frame,
- implement SERFF in all jurisdictions,
- move to a regulatory framework that recognizes market competition, and
- provide consumers with access to information on pricing and market conduct.

In addition, the recommendations encourage states to eliminate unnecessary regulations and add those that are necessary to establish the greatest degree of uniformity by December 2001.

⁹These products include individual term life policies, individual flexible premium deferred annuity contracts, and individual and group Medicare supplement policies.

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Both the state-based system and the limited CARFRA launch are tied to the progress states make in implementing SERFF. Insurers participating in the launch are to file for product approvals using this system. CARFRA review teams will use the SERFF system to review filings. Moreover, a filing using the SERFF system during the launch will be considered a filing with each participating state, and regulators from the launch states will have access to the SERFF files. NAIC expects 41 states to be using SERFF for either CARFRA or state filings by December 2001.

National Treatment of Companies Initiative

As with the procedures for licensing agents and approving new products, the process for licensing insurers that operate in more than one state has traditionally been costly and time-consuming. States often require different types of information and have different filing requirements. Companies planning to buy or merge with another insurer find that they are subject to review in each state where either company operated. These reviews cause delays and raise costs, creating a burden that some insurers believe could be alleviated by establishing a single federal insurance regulator.

State insurance regulators, working through NAIC, have begun to look for ways to reduce this burden on large multistate insurers, without the establishment of a new federal authority—that is, through greater regulatory uniformity at the state level. According to the insurance commissioners who co-chaired NAIC’s National Treatment of Companies Working Group, state regulators traditionally have not coordinated their procedures for company licensing, acquisitions, mergers, and solvency monitoring to any significant degree. Thus, NAIC has begun to focus on creating a state-based uniform regulatory process that could provide some of the same efficiencies as a single federal charter.

The primary result of these efforts to date is a streamlined insurer licensing procedure, the Accelerated Licensure Evaluation and Review Techniques (ALERT) program. The program uses the Uniform Certification of Authority Application (UCAA), a standard company licensing application that insurers can use to apply for admission in many states. Although states review each application independently, insurers need to fill out only one form. According to NAIC, 46 states and the District of Columbia were using UCAA as of July 3, 2001. NAIC expects that the four remaining states will join by July 31, 2001.

NAIC had planned to supplement the UCAA licensing process with a “national treatment” program that would include streamlined regulations and unified processes for not only licensing but also solvency monitoring, reporting of holding company transactions, and market conduct oversight. However, the effort to move to a single, unified process for supervising large multistate insurers now appears to have been abandoned or, at least, delayed indefinitely.

Currently, NAIC plans to work on coordinating efforts by state insurance commissioners and working groups to develop best practices for state regulatory processes to improve efficiency and consistency in licensing and corporate governance. NAIC also hopes to bring more coordination to the process for chartering or change-in-ownership applications (Form A filings). An NAIC committee anticipates describing its recommendations concerning new review procedures for standard holding company filings by September 2001. NAIC is also planning to create a Form A Database—a repository of state regulatory data designed to facilitate information-sharing between state insurance departments on acquisition and merger filings. This database was originally recommended by NAIC as a corrective action stemming from the insurance investment scam that was allegedly perpetrated by Martin Frankel.

Coordinating With Federal Regulators Initiative

The consolidation of financial services industries allowed by GLBA heightens the importance of consultation and information sharing between federal and state financial services regulators. Prior to the passage of GLBA, federal financial regulators and state insurance regulators did not routinely share regulatory information with each other. But as the distinctions and separations in financial markets continue to blur, both federal and state regulators have acknowledged the need to improve cooperation and information-sharing across financial industries in order to carry out their oversight responsibilities.

Recognizing this fact, NAIC has contacted federal financial regulatory agencies on behalf of state insurance regulators to facilitate information sharing, primarily through the use of bilateral information-sharing agreements. According to NAIC, the purpose of these agreements is to establish a relationship between state and federal regulators to facilitate communication and coordination. In September 2000, we reported that NAIC and some states had established information-sharing agreements with officials at the Federal Reserve Board, OCC, and OTS. Similarly, NAIC and state insurance regulators have also met with officials from FDIC to discuss information-sharing issues and areas of common interest. In our prior report¹⁰, we also observed that similar information-sharing arrangements had not yet materialized between insurance and securities regulators. Additionally, we noted that NAIC, state insurance regulators, and the Department of Justice needed to explore ways for insurance regulators to conduct criminal history checks using Federal Bureau of Investigation (FBI) information.

Since we reported on this topic in September 2000, the number of information-sharing agreements between state insurance departments and federal banking regulators has continued to grow. In December 2000, NAIC approved model regulatory cooperation agreements with the Federal Reserve Board, OCC, and FDIC. (NAIC had already approved a model information-sharing agreement with OTS in March 2000.) In March 2001, NAIC reported that individual states were in the process of signing agreements with banking regulatory agencies and that cross-training and educational sessions for insurance and banking regulators were being developed. By June 27, 2001, the number of states that had signed bilateral agreements stood at 45 with OTS, 13 with OCC, 14 with FDIC, and 4 with the Federal Reserve Board.

Progress in establishing information-sharing agreements between insurance and securities regulators has proceeded at a slower pace, although both NAIC and the Securities and Exchange Commission (SEC) appear to recognize the importance of this issue. In March 2001, SEC developed suggested legislative changes that would allow securities regulators to consider regulatory history data from insurance and banking regulators when making licensing decisions on individuals entering the securities industry. NAIC maintains that an ongoing dialogue with SEC has yielded significant progress to address common issues and concerns. However, as of May 2001, NAIC and SEC officials had not yet completed a model information-sharing agreement.

NAIC supports the concept of automated information sharing of regulatory data and criminal histories. In testimony provided in March 2001, NAIC said that it supported providing financial regulators with the means to access each other's data in order to help prevent the migration of rogues from one financial services industry to another. In particular, NAIC emphasized regulators' need to obtain criminal history data through the FBI in order to conduct nationwide criminal background checks on applicants desiring to enter the insurance industry. Though

¹⁰*Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight* (GAO/GGD-00-198, Sept. 19, 2000).

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legislative initiatives are currently being considered, insurance regulators do not yet have the same access to these data as banking and securities regulators.

Insurance Holding Company Initiative

As the consolidation of financial services industries continues, a fundamental regulatory question concerns how the different financial regulators will carry out their oversight duties under the financial holding company structure allowed by GLBA. Under the act, financial holding companies could be formed that included either or both insurance companies and securities firms together with banks. Prior to GLBA, this was not permitted. GLBA provides for functional regulation, that is, each of the regulated functions—banking, securities, and insurance—by the appropriate regulator, with the Federal Reserve Board as the umbrella regulator of the financial holding company. As a result, insurance regulators recognized that policies and procedures for conducting financial analyses, examinations, and other reviews on insurers belonging to holding companies would need to be reassessed given the new affiliations allowed under a financial holding company structure. As such, changes would necessitate increased coordination and cooperation between state and federal regulators. Insurance regulators also recognized the importance of reviewing how communication would take place between a state insurance department and other functional regulators of a financial holding company.

The Insurance Holding Company initiative grew out of the passage of GLBA. Recognizing the importance of regulating insurance activities within a financial holding company that could have multiple affiliates from different financial industries, NAIC formed the Financial Services Holding Company Analysis/Review/Examination Working Group in 2000. This working group was charged to

- assess the implications of GLBA on the regulatory authority, focus, and procedures provided in NAIC's existing Insurance Holding Company System Model Act and accompanying Model Regulation;
- evaluate the manner in which insurance groups should be reviewed by insurance departments, considering the use of consolidated financial statements and a special regulatory group report;
- determine the nature and type of information insurance regulators need from other functional regulators of noninsurance financial holding company affiliates in order to enhance the analysis and examination procedures for insurance companies;
- develop and document standard review procedures for acquisition or change-of-control statements (Form A), annual registration statements (Form B), transactions subject to prior notice (Form D), extraordinary dividends, and other significant filings; and
- make recommendations regarding mechanisms to enhance communication and coordination among all functional regulators, including the role of NAIC resources in supporting such communications and coordination.

In September 2000, NAIC reported that the Financial Services Holding Company Analysis/Examination/Review Working Group had received progress reports from its subgroups on each of the areas the working group was assigned, as previously cited. Highlights of the ongoing work included a review of GLBA in conjunction with the Insurance Holding Company Model Act, preparation of a draft discussion paper regarding group solvency monitoring, and the adoption of a proposed list of data elements for a Form A Database. NAIC officials also

emphasized the relevance of this working group to related efforts for enhancing communication and coordination among all functional regulators.

At its national meeting in December 2000, NAIC's Financial Services Holding Company Analysis/Examination/Review Working Group introduced a draft of *Framework for Insurance Holding Company Regulation*, dated November 10, 2000, for review and comment. The stated intent of this draft document was to (1) serve as a framework for state insurance regulators in supervising insurance holding companies and insurance subsidiaries of financial holding companies; (2) encourage initiative and cooperation among state insurance regulators for more effective and efficient state regulation; (3) provide a basis for discussion with the appropriate primary supervisors of a financial holding company's banking, insurance, or securities subsidiary; (4) provide standard review processes and procedures for holding company filings; and (5) address the report and recommendations of the Ad Hoc Task Force on Solvency and Anti-Fraud, dated April 13, 2000 (see enclosure VII). At the time, NAIC officials noted that the draft did not yet include detailed guidance for coordinating financial examinations among different functional regulators.

The working group also proposed changes and amendments at the 2000 Winter National Meeting designed to make two model laws more consistent with GLBA. Proposed changes to the Insurance Holding Company System Regulatory Act included establishing a 60-day period for regulators to review proposed affiliations or acquisitions involving holding companies and to clarify the level of assets that may be invested in an affiliated entity. Similarly, the working group proposed changes to the Investment of Insurers Model Act to modify an asset diversification requirement for consistency with GLBA.¹¹

At NAIC's national meeting in March 2001, additional guidance was disseminated on the scheduling of examinations and examination procedures related to the treatment of transactions between affiliated corporate entities. This guidance, detailed in a NAIC memorandum dated February 12, 2001, supplemented the November 10, 2000, draft document (previously described). In a status memorandum dated March 25, 2001, NAIC agreed to prepare a second draft of the *Framework for Insurance Holding Company Regulation* that addressed the latest additions and comments to date. NAIC officials emphasized that the working group's efforts apply to holding company structures in general, both traditional insurance and financial holding companies. To make this broader focus more explicit, the name of the working group was changed to the Insurance Holding Company Working Group.

The working group also proposed other changes to its original charge at the March 2001 National Meeting to recognize the expanded focus. The proposed changes to the charge included the elimination of the task to determine the nature and type of information insurance regulators need from other functional regulators, a task that overlapped with the Coordinating with Federal Regulators initiative. The proposed changes also included a task to consider several recommendations on corrective actions that were identified as a result of the insurance company failures tied to the scam allegedly masterminded by Mr. Frankel as well as a task to monitor the development and implementation of a Form A Database. Finally, the working group extended its deadlines for completing final reports and recommendations to NAIC's 2001 Winter National Meeting, rather than in the fall.

¹¹ Section 306 of GLBA provides that the state of domicile of the insurer may limit the investment in the voting securities of a depository institution or its affiliates to an amount that is not less than 5 percent of the insurer's admitted assets.

Market Conduct Initiative

Market conduct includes all issues related to the sale of insurance products to consumers of insurance. Many of the important issues are similar to those associated with the selling of securities products. They involve sales practices of companies and agents as well as such things as suitability—that is, the agent’s responsibility to match the appropriateness of the product sold to the needs of the customer, particularly those marketed to elderly citizens. Insurance policies are contracts that set out the insurer’s promise to pay a fixed amount under stipulated conditions at some future date. Consumers are often limited in their ability to compare the prices and features of insurance policies and thus may rely on the insurance seller or agent for information about the product. Given this situation, consumers rely heavily on insurance regulators for protection against deceptive and fraudulent sales practices.

Traditionally, the length of time previously needed for product approval resulted primarily from the time taken by multiple states to review the policy form (what the policy says) and to assure themselves that the price to be charged was appropriate for the product—i.e., high enough so the company would be able to pay all expenses and claims plus a reasonable profit, but low enough to be fair to consumers. This process, in many states, together with a mechanism for resolving consumer complaints, has been the backbone of consumer protection for insurance consumers.

While market conduct is not an issue that comes directly out of either GLBA or insurance industry pressures to “level the [competitive] playing field” with banks and securities firms, it is relevant to recent financial modernization efforts. With the streamlining of the product approval process, many state regulators have recognized a need for a more proactive, better-coordinated effort to oversee and examine the market conduct of insurers—somewhat analogously to the process used to oversee financial solvency. Currently, financial solvency regulation is encompassed in NAIC’s accreditation program, while requirements for a state insurance department’s market conduct program are not. Key elements of the Market Conduct initiative include:

- reviewing and making recommendations on underwriting and market practices that affect consumers,
- examining state programs and practices relating to market conduct,
- identifying issues and concerns caused by a lack of uniformity among states in regulating market conduct, and
- evaluating the merits of establishing voluntary uniform national standards for regulating market conduct.

To meet these goals, NAIC has developed plans involving a number of specific steps. First, it will scrutinize the existing information systems to identify ways they can be enhanced and to provide data for monitoring market conduct. As part of this effort, NAIC is also considering the need to develop both an annual report, to enable states to collect key information on market conduct, and a centralized database. Second, NAIC will continue to monitor insurance market conditions, including both underwriting and marketing practices, to identify key market conduct issues. NAIC will also provide a forum for discussing such issues, including at least one public hearing annually, and encourage states to provide information to help update an NAIC guide known as the *Handbook of Available Options*.¹² Along the same lines, NAIC will monitor the effectiveness

¹² In 1997, NAIC released a final report of its Insurance Availability and Affordability Task Force. This report included a section called *Improving Urban Insurance Markets: A Handbook of Available Options*.

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of voluntary industry compliance programs, particularly the self-examination program of the Insurance Marketplace Standards Association. Third, NAIC has created a number of working groups to tackle issues such as model legislation and consumer problems tied to the sale of credit insurance. Fourth, it has begun formulating recommendations on allowing access to NAIC Complaints Database for companies and consumers. Finally, NAIC has been working on recommended changes to the *NAIC Market Conduct Examiners Handbook* and to encourage its use by the states. One of NAIC's goals is to develop a national approach to market conduct examinations, promoting more efficient and timely examinations and better enforcement of rules governing market conduct. Discussion has already taken place on the idea of developing a "zone approach" to market conduct examinations that is similar to the approach used for financial examinations. As of June 2001, NAIC has not yet set firm time frames for completing these efforts.

**Status of NAIC Corrective Actions Recommended by the Ad Hoc Task Force on
Solvency and Anti-Fraud, April 13, 2000**

NAIC's Executive Committee established the Ad Hoc Task Force on Solvency and Anti-Fraud to gather input on possible improvements to regulatory programs and practices as a result of the scam allegedly perpetrated by Martin Frankel on a number of insurance companies in several states. These corrective actions were listed in our September 2000 report. The status of each corrective action recommended by the task force is outlined in table 3.

Table 3: Corrective Actions Recommended by NAIC's Ad Hoc Task Force on Solvency and Anti-Fraud

Types of corrective actions recommended	Complete	In progress	Planned
Level 1: Corrective actions generally considered by NAIC to be the highest-priority items that can be accomplished relatively quickly and that should not involve significant NAIC or state resources.			
A. Improvements to Accreditation Standards and Guidelines		X	
B. Improvements to Financial Analysis and Examinations Procedures	X		
C. Updates to Annual Statement Blanks and Instructions	X		
D. Establishment of a Form A Database		X	
E. Access to Antifraud Tools and Databases		X	
F. Improvements to Model Laws and Regulations		X	
Level 2: Corrective actions considered by NAIC to overlap current projects of other working groups, primarily those related to implementing the GLBA and other NAIC national regulatory priorities.			
G. Development of a Process for Coordinated Financial Examinations			X
H. Improvements to Financial Analysis of Consolidated Entities		X	
I. Development of Review Procedures for Holding Company Filings		X	
J. Improvements to Model Laws and Regulations			X
Level 3: Corrective actions that NAIC believes may require lengthy discussions and development or that involve significant additional NAIC or state resources.			
K. Improvements to Accreditation Standards and Guidance		X	
L. Improvements to Financial Analysis and Examinations		X	
M. Improvements in Antifraud Efforts		X	
N. Improvements to Model Laws and Regulations	X		
O. Improvements to the <i>NAIC Troubled Companies Handbook</i>		X	

Source: GAO summary of NAIC material.

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Level I

Corrective actions generally considered by NAIC to the highest-priority items that can be accomplished relatively quickly and that should not involve significant NAIC or state resources.

A. Accreditation Standards and Guidelines

1. The Financial Regulation Standards and Accreditation Committee was tasked to consider adding a model law and regulation that identifies requirements for asset custodians into NAIC's accreditation standards. As of April 30, 2001, the model law was adopted by the Financial Condition Committee at the NAIC 2001 Summer National Meeting. It will be considered by the Plenary and Executive Committee at the Fall National Meetings.
2. The Financial Regulation Standards and Accreditation Committee was tasked to consider adding a review team guideline to its "Use of Specialists" standard, requiring states to maintain the appropriate investment expertise. This review team guideline relating to investment specialists was adopted at the NAIC 2001 Spring National Meeting and provides examples of when an investment specialist may be necessary. This guideline will become effective January 1, 2002.
3. The Financial Regulation Standards and Accreditation Committee will consider adding a review team guideline to the "Procedures for Troubled Companies" standard, requiring proactive communication by the domestic state to other states that have a regulatory interest in a troubled insurer. This guideline was adopted at the NAIC 2001 Spring National Meeting, to be effective January 1, 2002.
4. The Financial Regulation Standards and Accreditation Committee was tasked to consider adopting a review team guideline requiring the use of an NAIC "Form A Database." This committee is awaiting the development and implementation of the Form A Database prior to developing a review team guideline requiring the use of such a database.

B. Financial Analysis and Examinations Procedures

1. The Financial Analysis Handbook Working Group adopted procedures to include an evaluation of investment management practices during the NAIC 2000 Fall National Meeting. These procedures were added to the *Financial Analysis Handbook*, effective December 31, 2000, to be used by analysts reviewing the 2000 annual statements.
2. The Financial Examiners Handbook Technical Group has developed additional examination procedures to evaluate the risk factors recommended by the Ad Hoc Task Force on Solvency and Anti-Fraud and to coordinate the use of investment specialists. These procedures were exposed to the Chief Examiners of all the states in late September 2000 and adopted by the technical group at the NAIC 2000 Winter National Meeting. These procedures were added to the investment analysis sections of the *Financial Condition Examiners Handbook*, effective January 1, 2001.

C. Annual Statement Blanks and Instructions

1. In October 2000, the Blanks Task Force was tasked to consider an interrogatory affirming whether an insurer's investments were in the custody of a qualified bank or were on deposit with the insurance commissioner. At the NAIC 2000 Winter National Meeting, the

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Blanks Task Force adopted Interrogatory No. 22, that required the insurer to disclose the amount of investments (1) held physically at the insurer's offices, (2) held as deposits by states or other regulatory authorities, and (3) held by a custodian. If held by a custodian, the interrogatory requires the insurer to disclose the name and address of the custodian or brokers with authority to make investments on behalf of the insurer as well as any changes in the custodian during the year. These interrogatory questions will be added to the Annual Statement Instructions in 2002, effective for all quarterly and annual filings beginning January 1, 2002.

2. In October 2000, the Blanks Task Force was tasked to consider an interrogatory affirming whether there had been a change in the bank that had custody of the insurer's investments. As noted above, the Blanks Task Force adopted Interrogatory No. 22, which addressed this issue at the NAIC 2000 Winter National Meeting. A description of the interrogatory and its implementation date are described above.

D. Form A Database

The Financial Condition Committee adopted specifications for the Form A Database at the NAIC 2000 Fall National Meeting. The Form A specifications were also reviewed by the Financial Services Holding Company Analysis/Examination/Review Working Group in 2000. The adopted specifications were referred to NAIC's Information Systems Division and a prototype was presented at the NAIC 2001 Summer National Meeting.

E. Anti-Fraud Tools and Analysis

1. NAIC has engaged in discussions with the National Association of Securities Dealers (NASD) to identify methods for shared database access between insurance and securities regulators. NAIC's legal staff are working on negotiations with NASD. NAIC anticipates an agreement will be reached sometime in 2001.
2. The Database Working Group of the Anti-Fraud Task Force was tasked to (1) compile detailed information on antifraud databases maintained by antifraud organizations, financial regulators, and law enforcement agencies and (2) identify criteria for access to such databases. The working group is developing a report detailing the most useful databases (e.g., related to insurance fraud, financial regulation, and law enforcement) and criteria for access. In addition, this working group continues to pursue obtaining access to the FBI criminal history data along with maintaining active membership in several organizations having antifraud-related databases. A final report is anticipated for the NAIC 2001 Fall National Meeting.
3. Where NAIC members can meet current criteria for access to antifraud databases of other organizations, the Database Working Group of the Anti-Fraud Task Force was charged with negotiating agreements with the appropriate organizations and encouraging state regulators to use available sources of antifraud data. NAIC's efforts to obtain access to the FBI information and the timetable for the task force's final report are described above.
4. The Unauthorized Entities Working Group of the Anti-Fraud Task Force was tasked at the NAIC 2000 Winter National Meeting to establish guidelines on the investigative and prosecutorial resources necessary to investigate insurance fraud. The working group has distributed a survey to all NAIC members soliciting information on antifraud resources,

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personnel, and accomplishments. Results of the survey will be used to help establish guidelines for insider fraud investigation; to establish general antifraud baselines and best practices; and to guide insurance department planning, budgeting, and staffing. The working group is developing a draft white paper on the investigation of insurance fraud by the NAIC 2001 Fall National Meeting.

5. The Federal/State Coordinating Working Group of the Anti-Fraud Task Force was charged to consider modifications to the Insurance Fraud Prevention Model Act at the NAIC 2000 Winter National Meeting. Specific issues to be considered include authority to investigate insider insurance industry fraud, law enforcement status of investigators, provisions granting prosecution authority, and other alternative means for obtaining prosecution resources. The working group adopted modifications to the Insurance Fraud Prevention Model Act at the NAIC 2001 Spring National Meeting. These modifications were approved by NAIC's Executive and Plenary Committees at the 2001 Summer National Meeting.

F. Improvements to Model Laws and Regulations

1. The Financial Examiners Handbook Technical Group was tasked to modify NAIC's model law and regulation that identifies requirements for asset custodians, namely, the Model Law and Regulation to Permit the Use of Clearing Corporations and Federal Reserve Book-Entry System by Insurance Companies. The technical group adopted amendments to the model law and regulation at the NAIC 2000 Winter National Meeting to require the custodian to provide independent notification to a state insurance department when a custodial agreement has been terminated or when the insurer withdraws 100 percent of the account balance in any one custody account. The model was exposed for public comment until May 23, 2001, and was adopted by the Examinations Oversight Task Force and the Financial Condition Committee at the NAIC Summer National Meeting. It will be considered by the Plenary and Executive Committee at the Fall National Meetings.
2. The NAIC/AICPA Working Group was charged with reviewing the Model Regulation Requiring Annual Audited Financial Reports and to consider modifications regarding notice to insurance departments when an insurer changes auditors. Upon this review, the working group determined that the current language does require notice to insurance departments when an insurer changes auditors, similar to SEC requirements. Consequently, the working group concluded that no modifications to the model regulation were necessary.

Level II

Corrective actions considered by NAIC to overlap current projects of other working groups, primarily those related to implementing the GLBA and other NAIC national regulatory priorities.

G. Coordinated Financial Examinations

1. The Insurance Holding Company Working Group has been tasked to consider developing a process for coordinating financial examinations of insurer groups. This working group is expected to present a final report to the Financial Condition Committee at the NAIC 2001 Winter National Meeting.

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2. The Insurance Holding Company Working Group has been tasked with developing statutory accounting guidance that will support consolidated accounting and reporting for groups of insurers. As noted above, the working group should issue a final report at NAIC's 2001 Winter National Meeting.

H. Financial Analysis of Consolidated Entities

1. The Insurance Holding Company Working Group has been tasked to develop a process for financial analysis of consolidated insurance groups. This working group is expected to present a final report to the Financial Condition Committee at the NAIC 2001 Winter National Meeting. The proposal contemplates a two-tier process:
 - a. NAIC's Financial Analysis Division will analyze Generally Accepted Accounting Principles (GAAP) financial statements, information from the Federal Reserve Board, and other available information on financial holding companies. Reports will be provided to states with a regulatory interest.
 - b. The states will analyze consolidated financial information on consolidated groups comprised solely of insurance companies and insurance-related entities.
2. The Insurance Holding Company Working Group has been tasked to develop annual and quarterly statement reporting requirements that will support consolidated financial statement filings. This working group is expected to present a final report to the Financial Condition Committee at the NAIC 2001 Winter National Meeting.

I. Procedures for Holding Company Filings

The Insurance Holding Company Working Group has been tasked to develop standard review processes and procedures for holding company filings. These procedures should include input of data to the Form A Database (previously discussed). This working group is expected to present a final report to the Financial Condition Committee at the NAIC 2001 Winter National Meeting.

J. Improvements to Model Laws and Regulations

The Insurance Holding Company Working Group has been considering whether to modify the model regulation that currently requires annual audited financial statements to also include consolidated audit reports. These audit reports would be used to support financial analysis of financial holding companies and the analysis of insurance company groups. This working group is expected to present a final report to the Financial Condition Committee at the NAIC 2001 Winter National Meeting.

Level III

Corrective actions that NAIC believes may require lengthy discussions and development or that involve significant additional NAIC or state resources.

K. Accreditation Standards and Guidelines

1. The Financial Regulation Standards and Accreditation Committee was tasked to consider adopting a Review Team Guideline requiring that significant elements of the Part A

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Accreditation Standards be reviewed during the financial analysis and examination processes. The committee added this requirement to the review team guidelines, which will require the accreditation teams to specifically consider this requirement in their scoring process. The committee exposed this change at the NAIC 2001 Spring National Meeting. It is expected to be adopted at the NAIC 2001 Fall National Meeting. NAIC expects the guideline to become effective January 1, 2002.

2. The Financial Regulation Standards and Accreditation Committee was tasked to consider revising the accreditation scoring system to include weighting of standards and individual review team guidelines. Upon consideration of this issue, the Committee concluded that all of the standards were equally important to an overall financial solvency program and thus believed each should be weighted equally. No revisions were considered necessary.
3. The Financial Regulation Standards and Accreditation Committee was tasked to consider revising the review team guidelines to add a requirement that troubled insurers be examined for frequently that once every 5 years. A requirement in the review team guidelines for more frequent examinations of troubled, or potentially troubled, insurers was adopted at the NAIC 2001 Spring National Meeting, to become effective January 1, 2002.
4. The Financial Regulation Standards and Accreditation Committee was tasked to consider adding review team guidelines requiring better communications with other state insurance regulators and state and federal banking regulators. The committee will address this task further upon the completion of work being performed by the Coordinating with Federal Regulators Working Group.

L. Financial Analysis and Examinations

1. The Financial Analysis Handbook Working Group was tasked to consider adding guidance in the Level One Checklist of the *NAIC Financial Analysis Handbook* requiring that significant elements of Part A Accreditation standards be reviewed during the financial analysis process. Such procedures are expected to be added to the *Financial Analysis Handbook* so that they can be incorporated into reviews of the 2001 Annual Statements.
2. The Financial Reporting Working Group was tasked to consider developing more specific guidance for the *NAIC Financial Condition Examiners Handbook* regarding the scheduling of examinations. Among the items being considered is that the timing of financial examinations should be more closely related to risk of insolvency and more use of limited scope, or targeted, examinations should be encouraged. This working group intends to prepare a final report by the NAIC 2001 Winter National Meeting.
3. The Financial Reporting Working Group was tasked to consider developing guidelines for the *NAIC Financial Condition Examiners Handbook* that would emphasize the risk assessment and management practices of insurers, including more emphasis assessing insurers operational controls. This working group intends to prepare a final report by the NAIC 2001 Winter National Meeting.

M. Improvements in Antifraud Efforts

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1. The Unauthorized Entities Working Group of the Anti-Fraud Task Force will recommend alternatives to provide expert assistance to state insurance departments investigating fraud, including the exchange of assistance, grant-funded programs from public and private sources, and increased capabilities at NAIC. In addition to developing detailed contact information on each state's insurance fraud director (or designated contact), the working group has researched grant programs and will determine applicability and eligibility requirements to begin the application process.
2. The Database Working Group of the Anti-Fraud Task Force will establish a goal to obtain access to criminal history data maintained by the FBI for state insurance regulatory licensing and investigative purposes. The working group will pursue this goal through either federal legislation or Executive Order.
3. The Anti-Fraud Task Force's Federal/State Coordinating Working Group was tasked to recommend a structure to facilitate the exchange of confidential information between insurance fraud authorities. The working group has gained access to the FBI's Law Enforcement On-Line (LEO) system, which offers a secure environment for electronic communications among state insurance departments, at no cost. The task force plans to present a report at the NAIC 2001 Winter National Meeting.

N. Improvements to Model Laws and Regulations

The Reinsurance Task Force was tasked to study the Assumption Reinsurance Model Act and the Disclosure of Material Transactions Model Act to determine whether significant reinsurance transactions should require prior notification or approval. The task force adopted amendments to the Disclosure of Material Transactions Model Act to require enhanced disclosure of new material reinsurance agreements. While the task force has not yet agreed that prior approval of such transactions is necessary, it will continue to assess the need for prior approvals.

O. Improvements to the NAIC *Troubled Companies Handbook*

The Financial Analysis Working Group was tasked to review and consider improvements to the NAIC *Troubled Companies Handbook*, particularly on the causes of potentially troubled companies. The working group adopted a workplan to address this charge at the NAIC 2000 Fall National Meeting. The workplan requires the Financial Analysis Working Group to adopt revisions to the handbook by the NAIC 2001 Winter National Meeting.

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