INCREASING THE EFFECTIVENESS OF STATE CONSUMER PROTECTION

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BEFORE THE

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OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

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INCREASING THE EFFECTIVENESS OF STATE CONSUMER PROTECTION

Tuesday, May 6, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATION,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 3:04 p.m., in Room 2128, Rayburn House Office Building, Hon. Sue W. Kelly [chairman of the subcommittee] presiding.

Present: Representatives Kelly, Hensarling, Garrett, Murphy, Brown-Waite, Barrett, Renzi, Maloney, and Davis of Alabama.

Chairwoman KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order. I just want to say that without objection all members' opening Statements will be made part of the record. Subcommittee chairs and ranking minority members will be recognized for five minutes each. All other members will be recognized for three minutes each for their opening Statements. We will alternate between the majority and the minority.

I am going to begin by simply saying that I have called this hearing today to review an issue that we feel is of utmost importance to all consumers, and that is the effectiveness of State insurance market conduct oversight. When it comes to insurance needs, consumers need to know that they are not being misled by products and that valid claims will be paid quickly. It is the responsibility of State insurance commissioners to efficiently regulate market conduct with the best interests of the American people in mind.

Consumers need to know, they need to understand, and we have with us today some people who will testify about what the current conditions are. We have Joel Ario, the Secretary-Treasurer of the NAIC and the Insurance Administrator of Oregon. He is going to testify that protecting consumers is the first priority of insurance regulation.

Commissioner Ario, I could not agree with you more, and we are here to make sure that State insurance regulators are up to the task.

The NAIC first began to look closely at market conduct regulation in the early 1970s and admittedly has made some modest improvements since then. Recently, both the NAIC and NCOIL have been reviewing the need to modernize market conduct surveillance to better serve consumers. They have come up with some interesting ideas, particularly after Chairman Oxley requested a GAO investigation. It is promising that there is a greater focus on achieving clear and specific guidelines for proper oversight. However, ideas will only get us so far, and the American people deserve action and they deserve action now.

Far too often, we have seen State legislatures fail to act upon good ideas of organizations such as the NAIC and NCOIL. It is only when Congress pressures the States, for example, with the NARAB provisions that I fought to include in Gramm-Leach-Bliley, that consumers finally get to see results. There must also be considerable coordination between States, as the varying nature of market conduct regulation from State to State is quite problematic. Across the country, we have seen consumers harmed by the current patchwork of State systems that involve too much duplication, with too few standards and no systematic approach to detect patterns of improper conduct.

The negative impact on consumers is two-fold.

First, consumers suffer higher prices and less choice due to overlapping, inefficient, requirements which needlessly increase the cost of doing business.

Second, consumers are exposed to bad actors who slip through the regulatory gaps due to improper targeting of resources. We need to develop a systematic comprehensive approach, with clear standards that will target resources more efficiently. Until then, a lack of consistency from State to State will continue to hurt all Americans by undermining protections and that drives up costs.

While State regulation of insurance market conduct has not served consumers well in some respects, I would like to stress that these inadequacies should not be interpreted as a need for more regulation, which could further harm consumers. Instead, I hope that we can, and I feel we must, work together to find an efficient and effective way to regulate insurance market conduct without creating more unnecessary burdens on the entire industry. Simply put, we do not need to pursue more regulation, but more effective regulation. I would like to thank all of our witnesses today for appearing before the subcommittee, and I look forward to hearing from you on how we can accomplish these goals.

We have been informed that Mr. Gutierrez has just had a new grandchild, so Mr. Gutierrez will probably not be able to make today's hearing. We congratulate Mr. Gutierrez, and I hope that his staff will deliver our congratulations to him. I understand how that feels, to be a new grandparent. It is a lovely feeling.

And now I would like to take care of one bit of business. The Subcommittee on Oversight and Investigations will come to order. Before we begin our hearing, the chair has one small piece of housekeeping.

The chair has been informed by the chair of the full committee that he is in receipt of a letter from the gentleman from Texas, Mr. Hinojosa, tendering his resignation from the Subcommittee on Oversight and Investigations. It is the chair's understanding that the gentleman from Alabama, Mr. Davis, who is here I believe today, will be elected to fill the subcommittee's vacancy at the next full committee meeting. Therefore, pending the action by the full committee, the chair asks unanimous consent that the gentleman from Alabama be permitted to participate in hearings held by this subcommittee as if he had been so elected. Is there any objection? If not, so ordered.

For further opening Statements, Ms. Maloney.

Ms. MALONEY. Thank you, Madam Chair, from the great State of New York. I thank you for having this important hearing. I thank the witnesses for appearing today before the subcommittee to share their views on State regulation of insurance and consumer protection.

The incredibly diverse and vibrant U.S. insurance market owes much to the preservation of regulation by the States. In many ways they act as individual laboratories and allow experimentation that is not possible on the federal level. The focus of State insurance regulators on their individual markets allows them the ability to develop thorough expertise that can benefit consumers and the industry.

I particularly appreciate the emphasis and the testimony of the Insurance Administrator of Oregon, which states that the first priority of State insurance regulation is protecting consumers. While State regulation has adapted to the changing insurance market for over 100 years, regulators face new challenges today to keep up with the new global financial services environment. Given these market changes, the GAO study is particularly timely conducted by the GAO, which provides a snapshot of how market analysis and market conduct regulation is being conducted in the States.

The GAO testimony acknowledges that the National Association of Insurance Commissioners is emphasizing the need for nationwide standards for market analysis and market conduct examinations to its members.

However, the GAO testimony highlights some major deficiencies in manner in which the States conduct this regulation and practice today. The GAO points to a lack of agreement on standards for examinations and training of examiners, inconsistent reliance by one State on the work of another, and an exam scheduled that overly burdens some companies and fails to adequately examine others. I believe these are serious fundamental problems that must be resolved to preserve the effectiveness of State insurance regulation.

While we focus today on market analysis and market conduct examinations, I look forward to continuing this discussion to the full range of State insurance regulatory issues. I thank the chairwoman for calling this hearing, and I look very much forward to your testimony.

Chairwoman KELLY. Thank you, Ms. Maloney.

Mr. Barrett? Mr. Davis, have you an opening Statement?

Mr. DAVIS OF ALABAMA. Thank you, Madam Chairwoman, and thank you for permitting me to be here today. Before my colleague from New York joined me, I was tempted to say that only in the House can you join a subcommittee and become ranking member on the same day, for at least a day.

Let me welcome the panel here today. I will not make a very long opening Statement. I would simply say this, one of the consistently vexing issues that we are facing right now as a body and as a committee is the byplay between the States having a lot of leeway to fashion their own regulatory structure, and the practical difficulty in a modern 2003 economy when predictability does not exist across the country. We face that in a host of contexts, from tort reform to preemption, and certainly to the kinds of issues that you are talking about today.

One of the advantages of being on this committee is that we do have a chance on a fairly regular basis to engage these issues in a somewhat non-confrontational fashion. We do have the advantage on a pretty consistent basis of engaging these issues in a manner that helps us learn, instead of one that automatically polarizes us. So I look forward to hearing your testimony and to being edified by it today.

Thank you, Madam Chairwoman.

Chairwoman KELLY. Thank you, Mr. Davis.

Mr. Hensarling?

Mr. Renzi?

Mr. RENZI. Thank you, Madam Chairwoman.

Thank you to our panel today for your testimony. I look forward to hearing it. I know we are looking at today the effectiveness of our State insurance markets. I particularly am concerned and I am interested in understanding a little bit of how we get away from so much of the patchwork of our regulation. I found as an insurance agent that it leads to what I feel is much more higher prices and less product choice. I would like to see more of an emphasis on regulations that are uniform as it relates to our licensing of agents, as well as kind of signature laws. I am hopeful today that some of your testimony will cover that, and I look forward to it.

Thank you.

Chairwoman KELLY. Thank you, Mr. Renzi.

Our panel today consists of the Honorable Terry Parke, Illinois State Representative, past President, the National Conference of Insurance Legislators.

He is accompanied by Mr. Robert W. Klein, Ph.D., Associate Professor and Director, Center for Risk Management and Insurance Research at the Georgia State University.

Then we have the Honorable Mr. Joel Ario, Insurance Administrator from the Oregon Insurance Division. He is Secretary-Treasurer of the National Association of Insurance Commissioners. We welcome you.

Mr. Richard Hillman, Director, Financial Markets and community investment at the U.S. GAO. We welcome you.

Mr. Brian K. Atchinson, Executive Director of the Insurance Marketplace Standards Association. We are glad to have you with us.

And then we have Mr. J. Robert Hunter, Director of Insurance, Consumer Federation of America. Welcome, Mr. Hunter.

And then Ms. Lenore Marema, Vice President, Legal and Regulatory Affairs, Alliance of American Insurers.

Thank you all very much for being here. We begin with you, Mr. Parke.

STATEMENT OF HON. TERRY PARKE, ILLINOIS STATE REPRESENTATIVE, PAST PRESIDENT, THE NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, ACCOMPANIED BY ROBERT W. KLEIN, PH.D., ASSOCIATE PROFESSOR & DIRECTOR, CENTER FOR RISK MANAGEMENT AND INSURANCE RESEARCH, GEORGIA STATE UNIVERSITY

Mr. PARKE. Thank you, Representative Kelly, members of the subcommittee.

My name is Terry Parke.

First, I would like to express my appreciation for having the opportunity to speak to you today. It is my privilege to represent the residents of Schaumberg and Hanover Townships in the northwest suburbs of Chicago, in the Illinois General Assembly.

It is also my privilege to have served as President of the National Council of Insurance Legislators, NCOIL, in 2001. In that capacity, I testified before the modernization of insurance regulation before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. In that testimony, I said an effective market conduct regulation would be essential to overall modernization. That testimony pointed out that strong regulation of conduct in the marketplace would be essential if States move from the present-day prior-approval system to strong regulation targeting actual company misconduct.

In today's testimony, I will provide you with the content of a preliminary report of the Insurance Legislators Foundation, as an educational and research arm of NCOIL. The primary report was received by the ILF on May 2 and will be the subject of a public hearing at the Hotel Intercontinental in Chicago on June 6. NCOIL is happy to release the document in conjunction with the holding of this hearing.

The preliminary report identifies fundamental and sweeping changes that would bring insurance market regulation as practiced today into the 21st century. It offers ideas that can bring insurance regulation in line with the reforms and new attitudes that have begun to take shape in the regulation of financial services in the United States and overseas.

The preliminary report points out that their needs to be a fundamental re-thinking of the philosophy and approach toward market conduct regulation and surveillance. In many respects, regulators have become de-factor quality control auditors for insurers. This is not an effective use of regulatory resources and does not serve the public interest. The present system has become a patchwork in practice, varying from State to State. It is arbitrary and places an excessive burden and uncertainty on insurers. The preliminary report contains ideas that would benefit consumers by eliminating costly regulatory redundancies. These redundancies increase the cost of products and stifle innovation. Such regulatory redundancy can also deter an insurer from entering markets and thereby reducing consumer choice.

Representative Kelly, members of the subcommittee, changes in market conduct regulation are essential and indispensable components of improving the efficiency and effectiveness of insurance regulation and insurance markets in America.

Today's report is part of a second and final phase of a four-year study of market conduct regulation which James Schacht of PricewaterhouseCoopers and Dr. Robert Klein of Georgia State University conducted. The first phase of that study compiled in 2000 found, among other things, widespread disagreement regarding the purpose of market conduct examinations, especially as to whether such examinations should focus on general business practices, or only on specific violations of law, and little coordination of market conduct examination by States, leading to widespread and wasteful redundancies.

Today's preliminary report responds to those and many other real-world, present-day issues. Critics say that the present market conduct surveillance system fails to acknowledge insurers' compliance programs, self-assessment, and independent assessment activities. The primary report shows how States could establish standards for effective compliance programs.

Most specifically, we envision a regulatory approach in which the CEOs of each regulated insurer would certify that the company he or she manages has operated in ways that do not harm consumers. In this new system, each CEO would certify to regulators that the company he or she manages has complied with the standards, or in the negative, would identify the standards that the company has not met, along with the steps to remediate the problem. Such self-policing systems would include incentives for insurers self-assessment activities aimed at determining improper market conduct practices.

In our earlier report, it was noted that 85 percent of the insurers surveyed performed critical analysis or retained independent assessors to detect improper market conduct practices. Self-assessment activities improve compliance, discourage violations and foster corrections.

This concept of self-policing is not unique to the insurance industry. Other regulatory agencies are shifting from prescribing specific behavioral controls to articulating principles of guidelines for companies to follow, and then allowing them to develop effective controls meeting them. The recent proposed anti-money laundering requirements for the insurance industry provide a clear example of this shift. The proposed rule for insurance companies concerning section 352 of the PATRIOT Act provides broad discrepancies, but allows insurers to establish specific program elements to achieve the intent of the section of the Act.

The preliminary report points out that there is often a lack of coordination with regard to multi-State examinations. The preliminary report identifies the need to give the domiciliary State the main responsibility for monitoring the surveillance activities of an insurer and its affiliates. Critics point to a lack of statutory authority with regard to market surveillance. Only two States——

Chairwoman KELLY. Mr. Parke, I am sorry to interrupt you, but you have five minutes and your five minutes are up. I would like to have you summarize what you are going to say. I want to inform all of our witnesses that your written testimony is in total in the record, and many of us have read your testimony. So we are asking you today to give a summary of what your testimony is. The green light means you have five minutes; yellow means you have one minute to sum up; and red means you are out of time. In the interests of making sure that some of the people who have flown in can get the planes to fly back out, I am going to try to keep this hearing to five minute segments.

So, Mr. Parke, I let you go over a little bit because in fact we had a little problem here with the lights, but at this point, if you could sum up, I would appreciate it.

Mr. PARKE. That is fair. I have to catch a plane myself, so I am along with the problem.

In essence, we have a report that we are going to make public today that addresses market conduct. We think it will talk about the concerns that this committee has expressed. We think that there needs to be a new approach to market conduct in which insurance companies and insurance regulators can use the resources to make sure that those bad actors are in fact held accountable. That can be done through market conduct. And the rest of the insurance industry that are complying, doing a good job and serving consumers and making a profit are not penalized for those that are not doing a good job. We think this approach is worthwhile and worthy, and we will push it at the NCOIL conference that will be established in a month at our summer meeting that will be in Williamsburg, Virginia.

[The prepared statement of Hon. Terry Parke can be found on page 102 in the appendix.]

Chairwoman KELLY. That sounds terrific, and I hope you will put a copy of that report in the hands of the staff here.

Mr. PARKE. That is already being done. Thank you.

Chairwoman KELLY. Good. Thank you so much.

Mr. Ario?

STATEMENT OF HON. JOEL S. ARIO, INSURANCE ADMINISTRATOR, OREGON INSURANCE DIVISION, SECRETARY-TREASURER, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. ARIO. Thank you, Madam Chair. My name is Joel Ario and I want to join Representative Parke in thanking you for holding this hearing this afternoon. Having read the comments of both Representative Parke and Mr. Hunter, I see there is no divergence there. There is a lot of divergence of opinion on this panel. I am anxious to get to the questions myself, so I will be brief in summarizing my written comments and really focus on four points.

First, as you have already mentioned, effective consumer protection, focused on local needs. This is the hallmark of State insurance regulation.

Second, because of this focus on local needs, this is not an area where one-size-fits-all works. It needs to be adapted to local circumstance.

Third, effectiveness and efficiency are not mutually exclusive. Effectiveness is most important, but we think there are many ways in which we can make the system more efficient as well.

And then finally, the foundation of an effective and efficient system is a rigorous market analysis program. I noted several mentions of that in the opening Statements. I think that is the foundation really that we are trying to develop for a program that draws on all the different areas of market regulation, to identify and respond to the real consumer problems in the marketplace.

Let me take you to those in turn. Gain, the purpose of State insurance regulation, and it has been this way for 125 years, is consumer protection. Insurance is a different kind of product than either banking or securities or really any of the other financial products out there. It is a more complex kind of product. What kind of policy will be offered to the consumer? What will be the price of the policy? What are the specific policy terms and conditions? What is included, what is excluded from the policy? What does the fine print say? Is a claim valid when it is filed? If it is valid, how much is it worth? These are all questions that are very complicated. They often lead to misunderstandings between consumers and insurers and they often lead to consumer complaints to our offices.

We handle on a national basis 3.5 million consumer complaints a year in the 50 States. That works out to an average of 7,000 complaints in every State. I would venture to guess that is an order of magnitude, or maybe more different than the amount of complaints that come in on the other financial service products. Responding to those consumer concerns, listening carefully to what the consumer says in those complaints, and trying to get to the real issues of those complaints—they are not all valid. There are some complaints that come in that are not, but a number of them, most of them raise important issues. Our job is to follow those complaints and address them in our marketplace and make that marketplace work for consumers at the local level.

Second point, this is not an area that one size fits all. There surely are areas where there is commonality. In the life insurance industry, we have recognized as regulators a number of parts of life insurance regulation that ought to be more uniform, and we are taking aggressive action to address those. But you get into some of the other lines of insurance, and the differences are important between the States. Terrorism is a different problem in New York than it is in my State of Oregon. Hurricanes and other kinds of disasters that befall coastal communities make for a much different homeowner market in Southern Florida than a homeowner market in the Midwest.

If you look at health marketplaces, you will see the way the local provider networks work, the way the hospital networks work, all have a fundamental effect on how the insurance products are delivered in those markets and how the insurance products are put together.

Some suggest, and Representative Parke just did, I think, that we could have a uniform system across the board for this, and usually it comes with the recommendation that he makes, which is that the State of domicile would be the appropriate State to take the lead. There is a lot of merit in that, and I think the NCOIL study is a good study that will help us move forward. But there are some problems with that kind of model, too.

Take the terrorism issue. Terrorism is not a big issue in my State. We have not had a lot of quarrels with the insurance companies over their terrorism coverage, their exclusions, and so forth. But I know in your State of New York, it is a much different situation. Superintendent Serio spends a lot of time on that issue. When

I call up Greg and say, “Gee, Greg, now that I have checked into this company that is domiciled here in Oregon and does business in New York”—I do not have a big carrier that fits this, but say I did—and called up Greg, and said, “I have checked them out, and on a generic basis, they do a good job with their terrorism filings with us, so just trust me, leave it alone, don’t worry about what they do in your market,” he would not be very happy, because he would say his marketplace is dramatically different than mine, and he has a different stance on exclusions. He has a different stance on a number of issues. I understand that. I agree with that. It is a different kind of marketplace. That is the kind of situation I think that we want to work on the problem, but it is not a one-size-fits-all type of situation.

Third point, there are efficiencies to be gained. A lot of this I think does and should focus on market conduct exams. One of our major initiatives at the NAIC this year is uniform exam procedures. We have identified four different areas in the examination process where we think there ought to be clear uniformity.

First is scheduling. If we can schedule in a consistent and uniform basis, we can minimize duplication.

Second, if we can do pre-exam planning in the same kind of way, we can then deliver to the companies clear expectations of what a market conduct exam is going to be, what is expected of the company, what the regulator will want to see.

And third, in the examination procedures, if we can do those more uniformly, we can have a more predictable process for everyone. It can be a more efficient process. It can be done more quickly and so forth.

And then finally, if exam reports are written in a consistent and uniform fashion, we can better understand and compare results.

I see I am already to the red light, too, so I will skip my last point on market analysis and make just a very quick conclusion. We again welcome this hearing. We will not get the job done that we want to get done by ourselves. You are right that the Congress pushing on us, NCOIL pushed on us, the industry pushing us, Bob Hunter pushing on us; all of those things are important to getting our job done. The worst case, the absolute worst case for us would be an overreaction to the problems and to create a one-size-fits-all federal solution. It just would not work for consumers.

Finally, the key for all of us is to keep our eye on the ball here, the main objective which is effective consumer protection.

Thank you.

[The prepared statement of Hon. Joel S. Ario can be found on page 36 in the appendix.]

Chairwoman KELLY. Thank you.

Mr. Hillman?

STATEMENT OF RICHARD J. HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Mr. HILLMAN. Thank you, Madam Chairwoman and members of the subcommittee. I appreciate the opportunity to provide you with GAO’s preliminary observations from our work on State insurance regulators’ oversight of market activities in the insurance industry.

My focus today is on, one, the States' use of market analysis and on-site examinations and market regulation; and two, the effectiveness of the National Association of Insurance Commissioners' efforts to improve these oversight tools and encourage the States to use them.

Regarding our first objective, on the States' use of market analysis and on-site examinations and market regulation, we found that all States do some level of market analysis, but few States have established formal market analysis programs to maintain a systematic and rigorous overview of companies' market behavior and to more effectively identify problem companies for more detailed review. The way State insurance regulators approach and perform market conduct examinations also varied widely across the States.

While NAIC has developed a handbook for market conduct examiners, States are not required to use it, and we found that it is not consistently applied across States. Moreover, the handbook is not intended to provide guidance for some important aspects of market conduct examinations; for example, how often examinations should be performed or what criteria States should use to select companies to examine.

We also found that the number of market conduct examiners differed widely among States and that there were no generally accepted standards for training and certifying examiners. These differences make it difficult for States to depend on other States' oversight of market activities. Most of the States that we visited told us that they felt responsible for regulating the behavior of all companies that sold insurance in their State, regardless of their State of domicile. Thus, even in those States that did market conduct examinations, the effort is often neither efficient nor effective because the pool of companies is too large for any one State to handle.

Moreover, since most States are not coordinating their examinations with other States, some large companies reported being examined frequently and sometimes simultaneously by multiple States, while other companies were examined infrequently or never.

Regarding our second objective, to assess NAIC's efforts to improve the States' market conduct programs, we found that since the mid-1970s, NAIC has taken a variety of steps to improve the consistency and quality of market conduct examinations. However, despite the NAIC's longstanding efforts and some limited successes, progress towards a more effective process has been slow.

Recently, NAIC has increased the emphasis it places on market analysis and market conduct examinations as regulatory tools that could improve States' abilities to oversee market conduct. With more consistent implementation of routine market analysis, States should be better able to use the resources they already have available to target companies requiring immediate attention.

Also by applying common standards for market conduct examinations, States should be able to rely on regulators in other States for assessments of an insurance company's operations. These improvements should, in turn, increase the efficiency of the examination process and improve consumer protection by reducing or eliminating existing overlaps and gaps in regulatory oversight.

However, if NAIC cannot convince the various States to adopt and implement common standards for market analysis and examinations, current efforts to strengthen these important tools for consumer protection are unlikely to result in any fundamental improvement.

In summary, we support the goal of increasing the effectiveness of market conduct regulation through development and implementation of consistent nationwide standards for market analysis and market conduct examinations across the States, in order to better protect insurance consumers. The emphasis placed on these issues by NAIC has increased substantially over the last three years.

We believe that NAIC has taken the first step in the first direction, however much work remains as NAIC and the States have not yet fully identified, reached agreement on, and implemented appropriate laws, regulations, processes and resource requirements that will support the goal of an effective uniform market oversight program.

Madam Chairwoman, this concludes my prepared statement. I would be happy to respond at the appropriate time to questions.

[The prepared statement of Richard J. Hillman can be found on page 64 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Hillman. I want to say that I found your report very interesting, very cogent. I hope our other panelists have a chance to read it.

Mr. Atchinson?

STATEMENT OF BRIAN K. ATCHINSON, EXECUTIVE DIRECTOR, INSURANCE MARKETPLACE STANDARDS ASSOCIATION

Mr. ATCHINSON. Good afternoon, Madam Chairwoman and members of the subcommittee. Thank you for the opportunity to speak with you today on this important topic.

I am Brian Atchinson, Executive Director of the Insurance Marketplace Standards Association. IMSA is an independent nonprofit organization created in 1996 to strengthen consumer trust and confidence in the life insurance industry through a commitment to high ethical market conduct standards. IMSA member companies comprise more than 200 of the nation's top life insurance companies, representing approximately 65 percent of the overall market share for individually sold life insurance, annuities and long-term care insurance products.

From 1992 to 1996, I previously served as Superintendent of the Maine Bureau of Insurance, and in 1996 as President of the NAIC. Prior to joining IMSA, I served as an executive officer in the life insurance industry. As a former regulator and company person, my views on market conduct regulation come from a number of different vantage points. Insurance regulation is intended to ensure a healthy competitive marketplace and to protect consumers.

We have come a long way since the first market conduct exams in the 1970s. Unfortunately, the current State-based system of market conduct regulation presents challenges that even some in the regulatory community acknowledge is in need of improvement. There is little uniformity in the manner in which individual States conduct market conduct exams. State market conduct exams have been described as being like snowflakes: no two are alike.

Insurance companies often are subject to simultaneous or overlapping market conduct exams from different States applying different laws and regulations. This lack of uniformity results in significant cost and human resource burdens on insurance companies that translate into higher costs ultimately passed on to consumers in the form of higher prices for their products. The challenge for regulators and for the industry is to create a uniform system of market conduct oversight that creates greater efficiencies for the insurance industry, while maintaining appropriate consumer protections.

The NAIC has been working toward uniform regulation for some time, but the pace of change has been slow and has prompted more efficient and effective alternatives. Regulators could improve the current system of market conduct regulation in several ways. For instance, today's market conduct exams tend to focus on identifying technical violations that may have little actual impact on consumers. Perhaps the focus should shift to exploring whether a company has a comprehensive system of policies and procedures in place to address market conduct compliance issues.

Also, State insurance departments should not view market conduct exam activity as a source of revenue or general fund subsidy. Rather, departments should be determining whether a company has a system in place to detect and remedy market conduct improprieties before they become widespread. This practice would allow market conduct regulation to better serve consumer interests.

IMSA's mission, the Insurance Marketplace Standards Association, is primarily to strengthen trust and confidence in the life insurance industry through high ethical standards. IMSA qualification also provides a consistent, uniform template of market conduct compliance policies and procedures. To meet IMSA standards, a company must have in place a comprehensive system of compliance throughout the organization, undergo an external assessment, and then undergo a new assessment every three years. Companies that qualify for IMSA devote considerable resources to maintaining those standards, and are well-positioned to respond quickly to State regulatory inquiries or to comply swiftly with new State legislative requirements.

The U.S. PATRIOT Act offers a prime example. As you know, this law gives federal authorities much wider latitude to monitor potential money laundering activity. Recently, the media reported that terrorists, drug dealers and other criminals may be using life insurance products to launder money. With an infrastructure of policies and procedures in place to detect and cure questionable sales practices based on IMSA's principles, an IMSA-qualified company is already in a good position to comply with the intent of federal anti-money laundering efforts.

In the last two years, IMSA has gained greater acceptance by regulators and rating agencies. In fact, a small but growing number of State insurance departments use IMSA membership and qualification as an informational tool as they plan and conduct market conduct exams. We applaud these efforts. With State insurance department budgets under tremendous pressure, we encourage regulators to pursue all available means to leverage increasingly limited resources. IMSA can serve as a valuable resource towards that end.

Neither regulators or companies alone can ensure that the marketplace is always operating in a fair and appropriate manner at all times. Organizations like IMSA, working in conjunction with regulators, can offer invaluable support to reform market conduct regulation and may even offer a blueprint for reform solutions.

In conclusion, IMSA believes the market conduct regulations should be more uniform and efficient, and we will continue to work with you, the NAIC and State and insurance departments to explore ways to improve market conduct regulation for the benefit of consumers, regulators and insurers alike.

Thank you very much, Madam Chair, for the opportunity to participate in this hearing and to address this important topic. Thank you.

[The prepared statement of Brian K. Atchinson can be found on page 59 in the appendix.]

Chairwoman KELLY. Thank you very much. You are my hero because you stayed within the five-minute line.

Mr. Hunter?

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Good afternoon, Madam Chair, members of the committee. I am Bob Hunter, Director of Insurance for Consumer Federation, a former Texas Insurance Commissioner, and Federal Insurance Administrator under Presidents Ford and Carter.

No one could deny that State insurance commissioners have a poor record when it comes to market conduct oversight of the insurance industry, and consumers have been abused as a result. We could go through many examples. The lack of excellence is particularly concerning in an era where less regulation of products is done at the time they are introduced, exposing consumers to greater risk of damage by bad insurance policies not reviewed by anyone at the State insurance department level.

The NAIC itself has Stated that greater, more aggressive consumer protections are needed in this new era, and we agree. The unique nature of insurance policies, which are complex legal documents not easily understood by consumers, and insurance companies that are granted antitrust exemption by the federal Congress, requires more extensive consumer protection than other consumer commodities. State systems should be designed to promote beneficial competition such as price competition, loss mitigation efforts, but to deter destructive competition such as selection competition, redlining in the cities and so on, reverse competition such as credit insurance where prices are driven up by high commissions and other unfair sales practices.

We believe that the following items are important to consider as you look for ways to upgrade the State market conduct oversight capacity. First, there should be minimum standards for market conduct examinations. That would be good for consumers. We have supported them on the national NAIC level and we would support them at the federal level, but we are very concerned about weak uniform standards. We are very concerned that that would lead to abuse.

The accreditation type of approach was very successful in upgrading State financial examinations might be used to achieve these kinds of goals. There must be enforcement criteria in the standards. There must be private causes of action as an important complement to market conduct examinations, because market conduct examinations are only prospective, and cannot grant restitution to already-harmed consumers, and consumers do not at this point trust the track record of the States.

Consumers oppose self-certification programs in the form that some have proposed, and specifically we oppose the NCOIL proposal that we have heard today. Self-certification in the post-Enron era is problematic at best. That is not to say self-certification could not be part of what a State looks at in determining whether an insurer is meeting State standards.

However, if a State relies on such information, it must be made public and the tests made by self-certification groups must be transparent. Consumer feedback should be used after policy terminations, claims denial and other actions by insurance companies. There ought to be a way of finding out not just complaints, but some kind of interview process periodically used by the States. There should be suitability rules in place, particularly for cash-value life insurance policies to assure that sales of proper products are made.

The NAIC should be requiring certain data to be collected, some of it for market shares, entries and exits and so on, but also zip code data to see if redlining is occurring; underwriting guidelines to determine how insurers decide what to write and how to price; and claims handling guidelines to determine the rules for claims processing. While there has been progress by the NAIC in details of how exams are to be done, they have not achieved effective or efficient examinations. Consumers want effective examinations. We also agree that efficient examinations is a good goal and we think that it can be improved without giving up effectiveness.

We need a thorough examination of what has gone wrong in previous market conduct exams that have missed a lot of really bad situations. It is hard to fix a system that has not been analyzed.

I would be happy to respond to your questions at an appropriate time.

[The prepared statement of J. Robert Hunter can be found on page 78 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Hunter.

Ms. Marema?

STATEMENT OF LENORE S. MAREMA, VICE PRESIDENT, LEGAL AND REGULATORY AFFAIRS, ALLIANCE OF AMERICAN INSURERS

Ms. MAREMA. Thank you. I am delighted to be here to represent the views of the Alliance of American Insurers. We are a national property-casualty trade association. We have 340 property-casualty insurance companies as our members, and our members range in all sizes, from the smallest to the very large companies.

What I thought I would do here in my five minutes is share some of our members' experiences with you about the current State market conduct examination system. Our members would share three concerns they have about the system with you. We would have three ways in which we think it can be improved. Then I would like to talk a little bit about how we think we need to proceed.

If our members had one overriding concern about the current market conduct examination system, it would be that States need to better target companies for examination. They need to target companies with problems. Many times our members really do not see among the States a rational basis for triggering an examination. I do not think I could State this better than one of the consumer groups did at a recent NAIC meeting when they said that the States really need to focus on the biggest problems, not the biggest companies.

Secondly, States need to better coordinate market conduct examinations. In the current system, each State can call an examination with little regard or any regard for what any other State is doing. It is not uncommon for a very large insurance company to have a dozen or more market conduct examinations pending at any given time.

Thirdly, there is a lack of consistency in examination procedures. The NAIC has a market conduct examination handbook that tells States how to do it, but there is a variety of different ways that States have implemented it. Just to give you on example, the handbook requires that companies get notified of the exam. The notice that a company could get can vary from six minutes to six days to sixteen days to sixty days, and it can be specific or it can be very general and so forth.

So those would be the three problems that I would cite from our members' perspective in the current system. What to do about that? Much has been made about the differences in State laws and regulations. I think if you are talking about market conduct examinations, I think we are talking more not about differences in laws and regulations, but difference in the 50 States' processes and 50 States' implementation of that. The lack of coordination leads to duplication and overlapping. Really, the inconsistent State procedures are the real problem.

Having said that, I think the groundwork is in place to change that. If you look at the NAIC's testimony, Superintendent Ario has listed a wide variety of market conduct activities that the NAIC has under way to correct some of these problems. But there are three of those NAIC initiatives that we think will produce real-time change in the current system.

The one is the market conduct analysis that they intend to develop. We think there is a wealth of information that already exists in the State insurance departments to help them better target companies for examination: consumer complaints, reports that companies do on major changes that they have made in their companies, and so forth. The appeal that this market conduct analysis has to us, it is something based on data that all States have; it is something they can all do; they can all do it now; the data that they have is applicable to all lines, all companies. I think it would bring States up to a certain bar that they would all be doing analysis on the same data in a consistent manner. That is a work in progress at the NAIC. It is going to take some doing to put together.

Secondly, they are doing an exam tracking system, the ETS. That is going to be an electronic system where there will be a centralized system of scheduling. That, to us, gives the States really the vehicle that they need to better coordinate an exam. When a State wants to call an exam, they will be able to look at the ETS and see what other States are doing with regard to that particular company.

And last, certainly, is the uniformity effort that the NAIC has going on, in particular some of the items in that. I would cite the standard data call. The NAIC has developed really the basic information that all States should need to do an exam in, and in the same format. That, from our companies' perspectives, those three items are going to be very, very helpful.

How would we proceed? The key here is going to be State implementation. I will say in my remaining time, from the Alliance perspective, real change is change in behavior in the State insurance departments that conduct market conduct exams. For example, it is a good thing for the NAIC to develop a standard analysis, but from our perspective success is when all States actually use it. It is good for them to develop an examination tracking system; that is really needed. But the success is when all States input their data into it. It is really good for them to develop uniformity in procedures for examinations, but the real key to success is when our members see an examiner coming through the door who utilizes those procedures.

My organization supports State insurance regulation. We think that it has served consumers best over time because it responds to local needs. We think the States can fix these problems. I think the NAIC has laid the groundwork and more importantly, we see a strong commitment from the NAIC leadership to do this. So we are operating from the presumption that the problem is going to be fixed at the State level and it will get done.

Thank you.

[The prepared statement of Lenore S. Marema can be found on page 88 in the appendix.]

Chairwoman KELLY. We thank you. I thank all of you for your testimony. In particular, I would like to go back to you, Mr. Parke, just for a minute, and talk to you. You mentioned the Illinois model in your testimony. Do you think that Illinois' system of insurance regulation focuses on less regulation on the front end and more on the back end? Do you think that that targets the insurance department resources in the areas that will most benefit the consumers, like the market conduct oversight? Do you think that that has worked well?

Mr. PARKE. As a matter of fact, the State of Illinois is one of the most competitive States in the union. We have some of the largest amount of insurance companies selling insurance in the State of Illinois. That is because the free market system works. Competition works. They regulate each other because competition requires that. The consumer is not left alone. The insurance department uses market conduct. It also regulates solvency and also takes a good look at consumer complaints.

In the State of Illinois, we find that there is an awful lot of members that have diverse thinking. I have been in the General Assembly 19 years and I have never really heard a whole lot of legislators pushing to change the current system that is there. And there are a lot of different points of view. We have some members that are very pro-consumer, and yet we do not see a cry from Illinois legislators to change the current system. Competition works when you leave it alone and let it function.

Chairwoman KELLY. What kind of coordination is going on between NCOIL and the NAIC to improve the market regulation?

Mr. PARKE. Well, the report that we have is going to be presented. We are going to review it on June 6 in Chicago, and then we are going to look at the next three meetings of NCOIL, starting with our Williamsburg program, to try to see what kind of model legislation can be derived from this report.

We believe that the model legislation that will be used by various legislators to be taken to the State capitals to be refined based on what the needs of that State's needs for market conduct would be, I think there is a strong cry to change the current system of market conduct, and I think that Illinois will be one of those, if I have anything to say about it, that will be presenting a new approach to market conduct. I believe progressive legislators in the other various States will do the same.

Chairwoman KELLY. Since you brought up the model legislation, what do you think the chances are of the model legislation actually getting there, and how long do you think it is going to take the majority of the States to pass the legislation in some kind of a uniform manner and with some sort of uniform implementation? As we have heard today, that is critical. I am asking this question because I authored the NARAB legislation and we are still working on it. So I am wondering how long you think it will take you to get this done.

Mr. PARKE. I think NARAB is a fine example, and I am glad you brought it up. Quite frankly, the goal was 29 States. We exceed that. We are at 42 States. Yes, there are two or three major States that have not done it, but quite frankly those States have internal questions and they have issues that are unique to those States, and I think that they are struggling and working through it. Eventually, I think that will come about and will happen.

As far as legislators, we believe in the next 12 months that we will present at NCOIL, probably sooner than that, a model bill that the legislators can take back to the various States. Again, fine-tune it based on what that State's needs are and what the consumers' needs are, and I think you will find that a great majority of the States will move forward with some kind of uniform market conduct program.

Chairwoman KELLY. Thank you.

Mr. Ario, you testified that it may make sense to shift some of the focus from the front end, review through the rate and form review process, to a combination of self-certification and back-end view through desk exams or other approaches. I wonder if you would talk to us a minute about that, just expand on that a little bit.

Mr. ARIO. Madam Chair, I would be happy to. I think the Illinois case is a good example. There is a competitive market there with more of a back-end approach. We are looking at this in Oregon. We are shifting some of our rates and forms analysts who currently spend all of their time looking at filings as they come through the front door, and still doing some of that.

I think Mr. Hunter makes some very good points about the need to look at some products, anyway, on the front end because of the complexity and the difficulty consumers have with those products. We are shifting some of that resource towards the back end and relying on self-certification, the kind of things that Brian Atchinson talked about. We have check-lists now on our web page that companies fill out to show exactly what their form does and does not contain. If we send a message to the companies that we are going to take them at their word on those things, as a starting point, but trust and then verify.

We are going to then go out and spot check on the back end whether those forms actually do comply in the way that they are certified to comply. We are probably going to have to catch some people doing it wrong, but if we do catch them and make examples of them, I think companies will get the idea, and I think it will improve the filings on the front end, frankly. A lot of the filings that come in now, since they know we are going to review them on the front end, some of the filings come in as kind of an opportunity to discuss; let's just throw it at the regulator and see what they think. If we have a self-certification and hold them accountable and then spot-check on the back end, I think that that system is workable, not for all products, but for some products.

Chairwoman KELLY. Thank you.

I am out of time. Ms. Maloney?

Ms. MALONEY. Thank you.

Mr. Hillman, my first question is for you. You indicated in your testimony that some States have some insurers that face multiple examinations from different States. Specifically, you described a situation in your written testimony where over a three-year period, three companies in your study of large companies were examined 17 times or more over three years, while six were examined between one and five times. I guess my question is, do you have any suggestions to correct this type of different treatment for different insurers?

Mr. HILLMAN. There is a wide variety of steps that the State insurance regulators could take to improve the efficiency and effectiveness of their market conduct examination programs. Perhaps one of the most important things would be the development of consistent standards for market analysis and market conduct examinations, so that one State can rely on the activities of another State in conducting those analyses and examinations.

Right now, because things are so inconsistent, there is no reliance on State activities and one State insurance department regulator believes they must look at all the insurance companies within their State—those that are domiciled and those that sell insurance, but domiciled in another State—rather than relying on the form of State insurance regulation.

In addition to consistent standards, we also believe that there needs to be more consistent laws, more consistent regulations, more consistent processes, and the development of resources with appropriate expertise to conduct market examinations.

Ms. MALONEY. Mr. Ario, would your organization be the one to come forward with these consistent standards?

Mr. ARIO. Ms. Representative, that is correct, yes. The one point that I would make on the exam——

Ms. MALONEY. Are you working on them?

Mr. ARIO. Yes. We are working on uniform standards for examinations and we are working on a uniform analysis system. I think Mr. Hillman is correct that those processes will help improve this sort of situation.

The one other comment I would make, though, is that without knowing exactly which companies we are talking about, in the property and casualty market, for instance, there are three large insurers that are the three largest insurers in almost all 50 States. They represent almost half the market. Given that there are different situations in different States, there may be reasons why different States would want to examine them. It should not be over the same issues. We need to solve that problem. But if States have different kinds of issues with the same company, you still may have a number of exams of the same company. It should not happen with small companies; it should not happen with companies that are only engaged in a few different States, but it will sometimes happen with larger companies.

Ms. MALONEY. First of all, I want to thank you for your testimony and for highlighting the incredibly complex situation facing insurance companies operating in New York City and State, the State and city that I represent, and their efforts to offer terrorism insurance. I agree that this situation poses very unique problems that demands the local expertise of New York regulators. But given the Statements by GAO and yours also confirming the findings of duplication of examination and varying levels of training for examiners, can you give the subcommittee any kind of specific date when you believe that the NAIC standards that you are working on will come forward? A year? Two years?

Mr. ARIO. Representative, I wish I could promise you a date certain for the whole nine yards here. What I can tell is that on the uniform exam procedures, which is the project that is furthest along for us, we have already 40 States self-certifying compliance with at least two of the four areas of uniformity. Our goal this year, which I think we will achieve, is more than 40 States self-certifying to all four areas.

The next step will be, again, trust but verify. We expect it of ourselves, too. We are asking the companies and Lenore and her crew to give us complaints when States certify and then in practice are not doing what they certified to. So there will be some implementation there, but that project will be more or less completed this year.

Market analysis; that is going to take maybe a couple of years, and to build the collaborative models, to build the trust among the States and the consistent reliance, that I would probably ball park at a three-to five-year time frame. This is not easy stuff. Insurance is complicated, as you suggest, with terrorism, and there are examples like that all across the board. I think the key, if I were in your shoes, would be to look at, is there steady progress, not so much is it done by a date certain, but next year if we have a hearing or when you are looking at what we are doing, have we made consistent, steady progress. That would be the way I would measure what is happening.

Ms. MALONEY. Just as a follow up, Mr. Hunter and the other witnesses, do you think that the self-regulation works, and the initiatives that are detailed, will they be successful in combating the existing inefficiencies in insurance market regulation?

Mr. HUNTER. Well, we are very skeptical, but if self-regulation is transparent and the States rely on it and we can see exactly what is going on, then we can trust it. But if it is a black box, then we are very afraid of it because we do not believe that certain companies are going to tell the truth. We know some companies are doing some bad things to consumers, and we cannot trust a black box system of self-certification.

Chairwoman KELLY. Thank you very much, Ms. Maloney.

Ms. MALONEY. Thank you.

Chairwoman KELLY. Mr. Barrett? Sorry.

Mr. Hensarling? No.

Mr. RENZI. Mr. Renzi?

[Laughter.]

Chairwoman KELLY. Mr. Murphy, were you here before Mr. Garrett?

Mr. Renzi?

Mr. RENZI. Yes, ma'am?

Chairwoman KELLY. You were here before either one of these two? I am just taking people in order. You are here, okay.

Mr. RENZI. Thank you, Madam Chairwoman. Thank you so much.

Gentlemen and ma'am, thank you so much for your testimony. I wanted to move to the subject matter of agent licensing reform. I know, Mr. Hunter, you are experienced in this field. I want to ask you, I know that with the 56 jurisdictions that we have under NARAB, I think Mr. Parke you spoke to the fact that you were proud of the fact that 49 of them——

Mr. PARKE. Forty-two.

Mr. RENZI. Forty-two have some sort of reciprocity as it relates. Is that also to agent licensing?

Mr. PARKE. It is basically agent licensing.

Mr. RENZI. Okay. As it relates to that, is there a uniformity there that has been established yet, so that an agent can go on, submit one application, one set of requirements, and then pay the individual fees by State?

Mr. PARKE. The answer is there are 38 States that are doing that now.

Mr. RENZI. Okay. So we have uniformity, not just reciprocity, but uniformity with 38 States, so that one application merges with all 38 States.

Chairwoman KELLY. Mr. Ario, do you want to answer that?

Mr. RENZI. Thank you.

Mr. ARIO. Yes. We are working hard on uniformity, but the question really is, I think, if I have a license in one State, if I am a resident agent, can I get into the other 49 States very easily? The answer to that is yes.

Another one of the hats that I wear is the President and CEO of a group called the National Insurance Producer Registry, which operates an electronic gateway. So I am an agent now in any one of the States. I can go up on that gateway and enter my information showing that I am an agent in good standing, and be licensed.

I think there are 15 States now that are on that electronic gateway, and there will be all 50 probably by the end of next year would be my guess. So although for resident agent purposes there may be differences in the laws, it does not really matter to the individual agent because they only want one resident license. They just want to be able to then, once they have that, to get into all the other States. That is what we are very close to achieving.

Mr. RENZI. So under your model, sir, an agent would be able to go online, fill out one application, provide maybe a photograph or fingerprints, and then pay individual fees by jurisdiction. I think we have 56 jurisdictions. And then you would be able to be quickly licensed. We have agents in my State who have waited months and months.

In one case, we got testimony in my State of an agency who provides an insurance product for nursing homes, very needed in the property-casualty field. And to maintain their licenses alone, they are paying probably close to $100,000 a year, if you look at the labor costs and everything else involved, never mind the time frame and the different requirements they are having to jump through to get it done. So under your model, you are saying that this will be accomplished within a year?

Mr. ARIO. I am not sure, Representative Renzi. I do not know which State you are from, but if it is not Oregon, you ought to come to Oregon because——

Mr. RENZI. Well, it does not matter what State I am from. What I am saying to you is, if I am a licensed agent in any State, will I be able to have not just the reciprocity, but the uniformity of a simple application, one application with individual fees, or is that not going to be in the future?

Mr. ARIO. Representative, for resident licensing, there still will be a need to go to the individual State where you are a resident and get that license.

Mr. RENZI. I understand that.

Mr. ARIO. But once you have that primary license, when within a year I think we will be at a situation, we are already at 15 States, I think we will be close to all 50 States a year from now. Once you have that license, you will be able to get licensed as a nonresident in all of the other States through an electronic licensing process.

Mr. RENZI. With uniformity, sir?

Mr. ARIO. It is not even really uniformity. It would simply be, all you have to do is say, I am a resident in good standing in X State. With that and your fee—we are still working on the fingerprint issue—but a few little things like that there would not even be another full application. We are trying to get the system close to driver's licenses. If you have a good driver's license in one State, you can basically drive in the other States. That is the system we are trying to get.

Mr. RENZI. Where are we headed on the idea of counter-signature laws as it relates to that kind of——

Mr. ARIO. I think counter-signature laws ought to be eliminated. It was one of the safe harbors in the NARAB provisions.

Mr. RENZI. Thank you.

Mr. Hunter, is there a harm to eliminating counter-signature laws?

Mr. HUNTER. Not from a consumer perspective, no.

Mr. RENZI. Okay. Can I ask the panel, anyone with the expertise, where are we on uniformity as far as advertising on the Internet? Is it the domicile State that controls the laws as it relates to insurance agents who advertise on the Internet and what content? Mr. Parke?

Mr. PARKE. Quite frankly, I would defer to the NAIC.

Mr. ARIO. Representative, advertising is I think a good example of an area that fits something that Mr. Atchinson said earlier, which is we used to spend a lot of time in our market conduct exams focused on fairly technical issues. Many of those were in the advertising area.

I know in our department, we used to spend maybe one-third of our examination time on advertising issues, pretty narrow advertising issues, that kind of question of exactly, is this an Oregon ad or was it done from some other States. We do not do advertising hardly ever in our market conduct examinations anymore, and we have not had any up-tick in consumer complaints. So I think that is an area where there is not a lot of consumer abuse. Mr. Hunter will give you some examples, there are some areas with the elderly and so forth, but by and large, I have not heard people worry too much about that issue.

Mr. RENZI. Thank you.

Thank you, Madam Chair.

Chairwoman KELLY. Thank you, Mr. Renzi.

Mr. Davis, welcome to our committee, and your first question period.

Mr. DAVIS OF ALABAMA. Thank you, Madam Chairwoman.

Mr. Hunter, let me direct my first set of questions to you. You were probably the most persistent critic of a multi-State regulatory framework. I want to ask you about a couple of premises behind that. I would imagine that the people on the committee who disagree with you would say that there might be very strong arguments for consistency with respect to, say, life insurance. There is not likely to be a lot of variation from State to State, by and large, in that area.

However, it would seem that there might be significant variation when it came to two other classes of insurance: property-casualty losses, given varying threats from weather in different parts of the country; and the second one, of course, just being general health insurance, where there certainly is a real sparsity of health care in some areas, and very good and abundant health care in other areas. How do you address, briefly, those two sets of concerns, that if we try to craft a more nationalized system, it will not be able to account for those last two classes of insurance?

Mr. HUNTER. Well, it will be more difficult, obviously. We have not opposed trying to craft multi-State approaches, as long as consumer protection is high and people are protected. We do get concerned about whether or not a consumer from State X that is harmed. Who is accountable? Who do they go to? That becomes a little bit of a problematic question, absent a federal approach where the government here is doing that.

But we think it is possible to craft multi-State approaches. We do not oppose them. What we really want to make sure is that consumers are protected, whatever the approach, whether it is a local approach or a national approach. If the protections are good, we are happy with it, as long as there are ways to observe how it is doing; there is transparency in the process.

Mr. DAVIS OF ALABAMA. Give me an example of a multi-State approach, for example, that would address weather differences in States that face some high-risk of weather adversity. I am trying to get some vision of what a multi-State approach would look like that was not national in character.

Mr. HUNTER. Well, you could have multi-States along the east coast and gulf coast of the United States dealing with the hurricane risk. There are multi-State approaches being used. In fact, one State, Florida, has taken some leadership, but most stakes look to Florida, for example, to certify that the models being used to project hurricane losses are fair and reasonable, so the other States rely. So I would call that sort of a multi-State approach on a very specific type of loss that is unique to certain parts of the country.

Mr. DAVIS OF ALABAMA. How do they handle causes of action that cross multi-State lines?

Mr. HUNTER. Well, the local State cause of action would apply, so that would be different. If a consumer was harmed and brought an action, it would be different, depending on the State even under a multi-State regulatory approach.

Mr. DAVIS OF ALABAMA. Mr. Ario, let me ask you the next set of questions. From your perspective, obviously your premise is you defend the multi-State patterns that the States do a consistently good and effective job of policing consumer violations. Having said that, I think we would all probably agree with Mr. Hunter's assertion that there have been numerous instances where for whatever reason States have failed and various companies have done a number of things that we would certainly frown upon.

To the extent that States are not able to do a more effective job, what is the reason for that? Is there some particular aspect of the States having to do their own enforcement that prevents them from being as effective as a national system might be?

Mr. ARIO. Representative, I think there has been in the past a lack of focus on the question of market analysis. In a lot of situations, I think, as has been testified by other members here, the question of who gets examined and when is one that is not clear and done in a rigorous way.

So that is why in our work we put a great deal of emphasis on the concept of analysis. We have a rich continuum of data that we get at the State level—3.5 million consumer complaints, hundreds of thousands, literally, or Braden form product filings, producer actions, investigations—all of which tell us a lot about what is going on in our marketplace. I think we need to put more rigor into taking that information, and in a more rigorous modeling kind of way, look at it, identify key data points, identify outliers on those data points, and then address them.

Market analysis, as the GAO report points out, is a relatively new concept. Everybody did it in one form or another, but it was not very rigorous and it was not a separate discipline. It is evolving now as a separate discipline. I think that frankly holds a lot of the key to addressing both the concerns of the industry and the consumers. On the industry side, we get away from the trivial problems and focus on the real problems. On the consumer side, we do not miss the problems; we identify the problems and get to them earlier. We are never going to find everything. Crooks are always clever, but we will find a lot more through market analysis.

Mr. DAVIS OF ALABAMA. I think my time has expired, Madam Chairwoman.

Chairwoman KELLY. Thank you very much.

Mr. Garrett?

Mr. GARRETT. Thank you and good afternoon, everyone. It is good to see somebody on the panel that I used to associate with when I was in my former days as a legislator myself. Good to see you again.

I will throw the first question out to you, Representative, and this is a little bit off the mark of the others, but it is something we were working on in New Jersey, and that is the standards on life insurance and the speed of proposals with regard to approval forms and what have you. NAIC had proposed interState compacts for speed of market reform of life insurance products. Can you tell us a little bit about where that is? Whether NCOIL, if you know, has endorsed that compact yet?

Mr. PARKE. We have not endorsed it formally. We are looking at it. The concept has just been out nine months or so, and they have proposed it. We are reviewing it at our meetings and talking about the pros and cons.

A concept like this is not an easy product to try and approach to doing something. There are members that have expressed strong opposition to this, and we have members that think that this is a direction that we have to go in for speed to market, to allow the financial services industry to be able to compete in a world marketplace. I think that is a driving factor that may ultimately pass that, but NCOIL has not taken a formal position on that issue.

Mr. GARRETT. Okay, thanks.

As someone who has been involved, not necessarily directly involved, with market conduct studies, but at least in the next room while they were going on, and seeing how they can impact upon the industry, on the company, I guess my question that I will throw out to the panel, if that is okay, and I think some of the testimony may have been along this line as well, is that the focus so much by the regulator is on the minutiae of it, and for those in the industry that are on the front line with the consumer would never say that it is the most important aspect of it.

Some may view the word as the technical side of the equation instead, as opposed to the other end of the equation where if you work for the department, you know that it is easy to see where the problems are and it is easy to see which ones of the companies are the problem companies, because those are the ones that are getting all the complaints to the department. How do we address that? Is that really more not just simply an issue of simply solving this by coming up with a uniformity standard, because at the end of the day you may still get a system that you already sign onto as the appropriate system and is uniform across the board.

Mr. Hunter would agree that it addresses consumer complaints at the end of the day, but is it a problem locally with the local department, the State department, the one that is enforcing it, still going after the minutiae as opposed to the overall end-game, which is to provide better service to the consumer?

Mr. ATCHINSON. If I might comment, certainly congressman, I think you touch on an issue I think that is becoming more prominent among most of us that have been studying this issue, which is how does one make sure that everyone is focusing on the forest and not just on the trees.

I think the PATRIOT Act was one recent example of looking to ensure that financial service companies have an infrastructure in place that will, as a matter of course, require ongoing tracking and checking and monitoring and ensuring that there is self-corrective action taken when in fact problems are identified, as opposed to waiting three or four or five years until the market conduct exam is conducted, and only then discovering something that if there was an infrastructure in place might have been self-identified and self-corrected early on. That is not to say that in every instance some of these technical violations may not warrant attention, but the experience has been that all too often there is such an obsession with checking the minutiae, that oftentimes some of the larger systemic issues are not identified or given the priority that they warrant.

The organization I am with, IMSA, is just one example of how those sorts of infrastructures can be supported and encouraged, and if anything can complement the work of the regulators.

Mr. GARRETT. I would suggest a couple of things that could help us focus on the bigger picture would be if the States would do some interviewing of some of the consumers that complain in more depth, and try to bring that together and look for commonalities; and some interviews of agents. Agents quite frequently on front line in knowing when something is going wrong in a company or many consumers are getting hurt; and also monitoring these lawsuit discoveries. There is a lot of documents that come out that are incredible gold mines of abusive behavior that should be somehow routinely looked at by the States.

Mr. PARKE. I would like to point out an observation in listening to the discussion. Because of the federal chartering of insurance is an issue that is underpinning a lot of the discussion, there is no guarantee, ladies and gentlemen, that you are going to solve the problems if you go to a federal charter. You are still going to have the underlying problems. That is not going to get solved just because you change from one venue to another. The other problem is the establishment of the huge bureaucracy that is going to be needed to take care of it. That system is being done in the various States.

The old analogy, do you want to deal with 50 monkeys or one big gorilla I think is an issue that you have to ask yourself. Do you want to deal with this issue? We believe that we deal well on insurance. Is it perfect? No. Are there flaws? Yes. Can we solve them? Yes. You are giving us direction. GLBA was a fine start to give us direction. I think we have shown the ability to perform, to do things, to take care of those issues that are brought to our attention.

Whatever you decide by virtue of your hearings to ask the States to comply with, I believe that we will make a good-faith effort and probably not only achieve, but exceed, as we have done with NARAL.

The other question that you have to ask yourself is, there is a $10 billion premium tax issue. The States will lose that if you go to a federal program. That is something that we cannot easily accept either. You are going to have to review what will you do with this $10 billion that States will lose if you move in that direction. So as a subcommittee, you have other questions on using market conduct as a basis.

I think nobody up here is complaining that market conduct is not an effective tool. It can be a lot better. We are going to move in that direction, and I appreciate having the opportunity to testify today before you.

Mr. GARRETT. If I can ask one more?

Chairwoman KELLY. Your three minutes over time and you did not get any testimony from Ms. Marema, so perhaps you would like to have her testify.

Ms. MAREMA. I just wanted to echo the need for market conduct analysis, better analysis, better targeting of companies. Of course, if you are not sure why you are there in the first place, it is easy to focus on minutiae. I think some of the reforms that we see the NAIC doing and that we think are the key ones, once States are better able to target companies, they are going to know why they are there. It is going to be easier to focus on the companies' general business practices and so forth.

Chairwoman KELLY. Mr. Garrett, if you want to ask another question, please do. There is no one else here and we have these witnesses. As long as we have the experts before us, the purpose of this hearing is to find out information so we can help get this running smoothly.

Mr. GARRETT. Well, and I do not want to delay anything, but that is the picture that appeared in my mind when you made the reference to the 50 monkeys out there, and I am not sure which department of insurance you are referring to among those 50 monkeys.

[Laughter.]

Mr. PARKE. It was an analogy. It was not directed at anybody.

Mr. GARRETT. So my question is not a flippant one, but just I guess falls on the lines that you were saying, and you as well, and that is, at the end of the day, the hearings that we hold today hopefully drive home the effort to achieve the appropriate uniformity with regard to the market studies that are done.

The question is, as we leave here, do we have a role, then, on the federal level in having the federal government take a preemptive step with regard to the market studies themselves, or is it appropriate for your analogy of the 500-pound gorilla to step into that role as far as conducting them? Or is our role here simply to try to facilitate and get to the optimum level of uniformity as far as the studies that are being done?

Mr. PARKE. If I could address the, I will tell you that the message that you send today is heard and understood, and I take it back to legislators from the various States at our meetings. I tell them, they mean business; they expect changes; they expect uniformity; they expect reciprocity; and they expect market conduct to be more effective and efficient. That is the message I am taking back, and I think we hear your message loud and clear that there is pressure on you to try and make a difference, and the consumer ultimately is the goal that we all have to protect and make sure that they have a competitive product to solve the problem that will come from insurance.

Chairwoman KELLY. Mr. Parke, I think there is no one on this committee that would object to your taking that message back and disseminating it to the 50 monkeys.

[Laughter.]

Mr. PARKE. You got it. You got it.

Mr. ARIO. Terry has analogized this to monkeys. I will analogize this to my nine-year-old son, as State regulators. My nine-year-old son, he needs to be encouraged and pushed and cajoled into doing the right thing, but I have to let him get it done himself, and usually if I try to force the issue beyond a certain point, it is counterproductive.

I think that is basically where we are on this issue. We need to be pushed and pushed hard to do the right thing, but to try to force us at this point into anything through some federal legislation I think would end up being counterproductive.

At some point, if it does not happen, I think you have to look at other options. But at this point, I think you have got receptive ears out here, so I think these kinds of hearings are the kind of means that ought to be used.

Chairwoman KELLY. Mr. Atchinson, do you want to add something there?

Mr. ATCHINSON. I just wanted to add my voice to that last point, because I certainly think that there is a lot of good work being done, but I think the role that this subcommittee and the committee can play is to help focus and prompt the sort of action that is being considered and contemplated. I refer to my tenure as a regulator going back 10 years ago, and while there are a lot of good intentions, some of the initiatives launched then to reengineer regulation are still under way today. I do think that deadlines have a way of focusing most any of us, and that would apply to the organizations participating in this hearing.

Thank you.

Chairwoman KELLY. Thank you, Mr. Atchinson.

The chair notes that some members may have additional questions for this panel and they may wish to submit those in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses and to place their responses in the record. This hearing has been very interesting and I hope it is moving us along in the right direction. We gratefully thank you for spending as much time as you have.

This hearing is adjourned.

[Whereupon, at 4:30 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 6, 2003

OPENING STATEMENT OF REP. SUE KELLY
CHAIRWOMAN
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
"Increasing the Effectiveness of State Consumer Protections"
May 6, 2003

I have called this hearing today to review an issue of the utmost importance to all consumers: the effectiveness of State insurance market conduct oversight. When it comes to insurance needs, consumers deserve to know that they are not being misled by products and that valid claims will be paid quickly. It is the responsibility of State insurance commissioners to efficiently regulate market conduct with the best interest of the American people in mind.

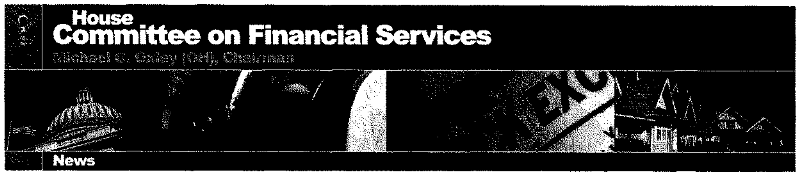
We have with us today, Joel Ario, the Secretary-Treasurer of the NAIC and the Insurance Administrator of Oregon, who will testify that protecting consumers is the first priority of insurance regulation. Commissioner Ario, I could not agree more, and we are here to make sure that State insurance regulators are up to the task.

The NAIC first began to look closely at market conduct regulation in the early 1970's, and admittedly has made some modest improvement since then. Recently, both the NAIC and NCOIL have been reviewing the need to modernize market conduct surveillance to better serve consumers. They have come up with some interesting ideas, particularly after Chairman Oxley requested a GAO investigation. It is promising that there is a greater focus on achieving clear and specific guidelines for proper oversight; however, ideas will only get us so far and the American people deserve action. Far too often, we have seen State Legislatures fail to act upon the good ideas of organizations such as the NAIC and NCOIL. It is only when Congress pressures the States – for example with the NARAB provisions I fought to include in Gramm-Leach-Bliley – that consumers see results

There must also be considerable coordination between States, as the varying nature of market conduct regulation from State to State is quite problematic. Across the country, we have seen consumers harmed by the current patchwork of State systems that involve too much duplication, with too few standards, and no systematic approach to detect patterns of improper conduct. The negative impact on consumers is twofold. First, consumers suffer higher prices and less choice due to overlapping, inefficient requirements which needlessly increase the cost of doing business. Second, consumers are exposed to bad actors who slip through the regulatory gaps due to the improper targeting of resources. We need to develop a systematic, comprehensive approach with clear standards that will target resources more efficiently. Until then, a lack of consistency from State to State will continue to hurt all Americans by undermining protections and driving up costs.

While State regulation of insurance market conduct has not served consumers well in some respects, I would like to stress that these inadequacies should not be interpreted as a need for more regulation – which could further harm consumers. Instead, we must work together to find an efficient and effective way to regulate insurance market conduct without creating more unnecessary burdens on the entire industry. Put simply, we do not need to pursue more regulation, but more effective regulation.

I would like to thank you for appearing before the Subcommittee today. I look forward to hearing from you on how we can accomplish these goals.



Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations
Increasing the Effectiveness of State Consumer Protections
May 6, 2003

Insurance is the glue that holds our economy together. But the glue only sticks if state insurance regulators ensure that promises are fulfilled. When a bad actor makes misleading sales promises or fails to pay valid claims, both the consumer and other insurers are hurt by the unfair competition. The linchpin of the insurance marketplace is trust, and our economy cannot function without it.

State market conduct regulation strengthens the reliability of this trust. The NAIC developed its first handbook for market conduct exams and did its first detailed study of the issue in the early 1970s. The states are now performing well over a thousand market conduct examinations annually, with between 1,000 and 2,000 analysts and examiners keeping the system honest.

Unfortunately, as noted in the GAO testimony, the way that states approach market conduct oversight varies widely, and few states have established formal market analysis programs to review companies' behavior and identify problem patterns to better target reviews. Furthermore, as noted in the NCOIL study, most state market conduct exams have been conducted without clear-cut standards for compliance. This has resulted in a system lacking both strategic design and uniformity, with the rules of the game too uncertain, and limited state resources wasted on inefficient and often duplicative regulation.

Consumers suffer a "double whammy" getting hurt twice by this inefficient system – once by absorbing the increased system costs from unnecessary regulation in the form of higher prices, and again from breaches of trust where states have insufficient oversight due to the failure to properly target resources. Too often we have witnessed the "gotcha game," where state insurance commissioners initiate duplicative and costly oversight exams and negotiate administrative fines for subjective wrongdoing that makes good PR, but bad public policy. Consumers deserve better.

It is imperative that we rethink the fundamental goals of market conduct – to fulfill consumer trust – and design and implement a comprehensive, uniform approach with standards that are clear, objective, and properly enforced. We need agreement on which consumer protections are most important, and then we need to develop uniform standards with best practice guidelines that companies can understand and implement. The states then need to implement oversight of these standards in a uniform and objective manner, so that companies and consumers know what to expect, and states can rely on the adequacy of each other's exams.

My home state of Ohio is at the vanguard of efforts to improve market conduct oversight and is one of the first states to develop a program that uses computer technology to analyze millions of pieces of already reported information to determine where specific anomalies exist and target resources accordingly. No state can afford to examine every insurer and agent on an ongoing basis, nor would such additional regulatory costs be efficient for consumers. But by using sophisticated data analysis, combined with appropriate best practices oversight of insurers' internal controls, states can coordinate and redeploy resources so that each is adding value to consumers in the most effective and cost-efficient manner.

I asked the GAO to conduct a review of state market conduct efforts to help underscore the importance of coordinating a more uniform, targeted approach to consumer protection. Based on our ongoing discussions with the GAO, NCOIL, the NAIC, IMSA, and others, I believe that we're reaching agreement on the fundamental nature of the problem and are nearing agreement on a framework to fix it.

Development of principles and guidelines by the NAIC or a model law by NCOIL is not enough, however. Many noble reforms have been later ignored and left on the dust heap of failed insurance reforms. Subcommittee Chairwoman Sue Kelly called this hearing today to underscore the importance of following through on these initial state efforts and our Committee's commitment to ensuring their uniform implementation by the states. We will be discussing a number of short-term legislative proposals to fix the state system later this year, and hope that the states can act quickly and effectively in this case to protect consumers on their own before Congress needs to step in and provide additional impetus.

I would like to thank the Chairwoman for her leadership efforts and the witnesses for appearing before us today.

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OPENING STATEMENT OF LUIS V. GUTIERREZ RANKING DEMOCRAT SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS "INCREASING THE EFFECTIVENESS OF STATE CONSUMER PROTECTIONS" MAY 6, 2003

Good afternoon, Madame Chair, and thank you for holding today's hearing.

During this hearing, I look forward to gaining further insight on state initiatives aimed at protecting consumers and improving market conduct standards. To better protect consumers, market conduct guidelines need to be updated with higher standards, and the input of the consumers in the developments of these guidelines is of upmost importance.

Reaching consistency in market standards is an important goal, but variations in state populations and consumer demands need to be considered since consumer needs vary depending on each community's population structure.

Furthermore, state insurance department resources need to increase to adequately protect consumers. It makes no sense to talk about ways to better protect insurance consumers, if we don't provide the critical resources to the state insurance departments responsible for protecting them.

So what can be done to strengthen the current system? For one thing, all consumers should have access to adequate coverage and be protected from redlining, life insurance market conduct abuses, race-based life insurance pricing and all other forms of discriminatory practices. In addition, consumers should have access to timely and meaningful information regarding the costs, terms, risks and benefits of insurance policies.

Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and provide for strong enforcement standards.

Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protections against loss. Components of the insurance policy must be clear to the consumer, including the actual current and future cost, as well as commissions and penalties.

In addition, insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, such as seniors, low-income, low-formal education and recent immigrants.

This should include redlining reviews through analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria, such as credit rating, reviews of pricing methods and reviews of all forms of underwriting instructions. Insurance companies also should be required to invest in communities by marketing and selling policies to prevent or remedy availability problems in communities.

To conclude, we should research the increased use of credit-based insurance scoring and assess the negative effect it is having in consumer's ability to purchase insurance coverage. Low credit scores can prevent someone from being insured at all. The practice has stirred complaints across the country from consumers who feel the use of credit scoring for services unrelated to credit is both discriminatory and invasive.

The mix of information is used to compile a credit score which includes much more than just the timeliness of payments. The methodology includes items such as the outstanding debt a person has and the number and type of open credit lines.

Given the fact that currently 90 percent of property insurers use credit scoring as a determining factor in their approval process and as a means to derive rates, we have an obligation to look at this matter carefully.

A major problem with the use of these scores is the lack of consistency in how scores are established and an unwillingness on the part of the insurers to reveal publicly how they determine scores. Without a standard to fall back on, and without insurance companies being required to reveal how they tabulate scores, there is no way to make sure consumers are protected from discrimination.

Thank you again, Madame Chair, for this timely hearing. I look forward to the testimonies that will be presented today.

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Oversight and Investigations

Committee on Financial Services
United States House of Representatives

Regarding:
"Increasing the Effectiveness of State Consumer Protections"

May 6, 2003

Joel Ario
Insurance Administrator
Oregon

Testimony of Joel Ario, Secretary-Treasurer
National Association of Insurance Commissioners

Introduction

My name is Joel Ario. I am the Insurance Administrator for the State of Oregon, and this year I am serving as Secretary-Treasurer of the National Association of Insurance Commissioners (NAIC). In addition, I serve as Chair of the NAIC's Market Regulation & Consumer Affairs Committee. I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Oversight and Investigations with an update of our efforts to modernize market regulation of insurers and agents to make that regulation both more effective and more efficient.

Let me start by observing that effective consumer protection focused on local needs is the hallmark of state insurance regulation. The preface to the Oregon Insurance Code states that the Code is to be "liberally construed for the benefit of the insurance buying public." I take that mission very seriously, as do other state insurance regulators, because we recognize that protecting consumers is the real purpose for government regulation of insurers and agents. We understand America's varied blend of local and regional markets, as well as the needs of consumers in these markets. Meaningful evaluation of proposals to improve the state regulatory system must begin with a hard look at their impact on consumer protection.

This focus on consumer protection does not in any way mean that state insurance regulators are not concerned with efficiency in carrying out our regulatory responsibilities. In fact, it is clear that a healthy, competitive industry is vital for consumers since the worst case scenario for consumers is to have no insurers available to meet their insurance needs. Inefficient and burdensome regulation is bad for insurers, and it also is bad for consumers. That is why our modernization program focuses on both effectiveness and efficiency.

Building on this framework, I would like to make three points today.

- **First, NAIC and the states are well underway in our efforts to modernize state market regulation.** In some areas, our goal is to achieve national uniformity because it makes sense for both consumers and insurers. In areas where state differences are justified because they reflect local or regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets. As you might guess, there are some tough judgment calls as to when uniformity or at least reciprocity makes sense, versus when differences should be respected and preserved as appropriate responses to local needs. But we are engaged in the process and we are making progress as I will discuss today.

- **Second, market regulation is more difficult to harmonize than financial regulation.** On the financial side, NAIC and the states have developed an effective accreditation system that is built on the concept of domiciliary deference (i.e., the state where the insurer is domiciled takes the lead role). This makes eminent sense because financial records do not change state to state; if one state has reviewed financial records and determined a company to be in good standing, it would truly be redundant for another state to review those same records. On the market side, it is not as straightforward. The market behaviors of insurers can be quite different from one state to another, both because the laws may be different and because insurer compliance with the laws may vary by state. In short, market regulation is definitely not an area where "one size fits all" across the country.

- **Third, the balance between uniformity and state diversity varies by line of insurance.** Life insurers have made a strong case for uniformity in product review standards, partly on the basis that the underlying financial risk that they insure does not vary by state and therefore product standards should not vary. Property and casualty insurers have not made the same case, because they recognize that the underlying risks they insure do vary by state. An urban state has different risks in its auto market than a rural one, Florida has different catastrophe risks than Kansas, and so on. Health markets also differ markedly by state given that health costs depend on variables such as hospital and provider networks, and population demographics. In this context, our modernization work has struck different balances in different lines of insurance.

Protecting Consumers is the First Priority of State Insurance Regulation

Government regulation of insurance companies and agents began in the states well over 100 years ago for one overriding reason – to protect consumers. Our most important consumer protection responsibility is to assure that insurers remain solvent so they can meet their obligations to pay claims. But state regulation has always had an equally important second purpose: to ensure that consumers are treated fairly when they purchase insurance products and file claims. Unlike most products, the purchaser of an insurance policy will not be able to fully determine the value of the product purchased until after a claim is presented — when it is too late to decide that a different insurer or a different product might make a better choice.

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure that the promises made by insurers are kept.

Protecting insurance consumers in a world of hybrid institutions and products must start with a basic understanding that insurance is a different business than banking and securities, with multiple decision points that impact consumer protection concerns: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? What risks are excluded from coverage? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms?

When consumers believe they have been mistreated by insurers, they look to regulators for assistance and there can be significant consumer backlash and customer dissatisfaction absent effective regulatory attention. During 2001, state regulators handled approximately 3.5 million consumer inquiries and complaints regarding the content of their policies or their treatment by insurance companies and agents. Many of those calls led to a successful resolution of the problem at little or no cost to the consumer.

As regulators of insurance, state governments are responsible for responding to the expectations of American consumers – including those who are elderly or low-income – regarding financial safety and fair treatment by insurance companies and agents. State insurance commissioners are the public officials who are appointed or elected to perform this consumer protection function. Nationwide in 2001, we employed 12,300 regulatory personnel and spent $942 million to be the watchful eyes and helping hands on consumer insurance problems. The states also maintain a system of financial guarantee funds that cover personal losses of consumers in the event of an insurer insolvency. The entire state insurance regulatory system is authorized, funded, and operated at no cost to the federal government.

Finding a Regulatory Balance that is Effective and Efficient

Efforts to improve market regulation must start with the fact that it is multi-faceted, and that the best way to make market regulation both more effective and more efficient is to focus on bringing more coordination to the various facets of regulation. NAIC has identified seven major market regulatory components that are common to all state insurance departments, even if not always defined and organized as separate activities:

- Consumer complaint handling
- Producer licensing
- Rate and form review
- Market analysis
- Market conduct examinations

- Investigations
- Enforcement

In addition, state insurance departments typically include various other ancillary activities, such as consumer education and outreach, especially to vulnerable populations; oversight of residual markets, and antifraud programs.

It is important to start with this list because many of the efforts to modernize market regulation involve taking an integrated view of how the various market regulation functions can work together, rather than looking at specific functions in isolation. For example, it may not be sensible to simply deregulate the rate and form review process, but it may make a lot of sense to shift some of the focus from "front end" review (the traditional approach) to a combination of self certification and "back end" review through desk exams or other similar approaches. Similarly, it may not be sensible to simply cut the number of market conduct examinations, but it may make a lot of sense to shift some of the focus from on-site, comprehensive examinations to more reliance on less intrusive market analysis techniques that identify outliers and allow for more careful targeting of examinations.

Appendix A to my testimony includes detailed summaries of current NAIC work on each of the seven key market regulatory functions. What I want to focus on here, though, is two broad themes that underlie much of our work to modernize market regulation: market analysis and collaboration among the states.

A central reform currently being pursued through the NAIC is to better define and elevate the importance of market analysis as the most effective regulatory tool for drawing on all of the market regulation functions to target the most serious consumer problems. While much industry criticism focuses on market conduct examinations, they are only one piece of a broader system of state oversight activities that include ongoing information gathering and analysis to spot problems as early as possible and correct them. Market conduct exams are a useful tool, but even if sufficient resources were available to conduct more of them, such exams must be complemented by other regulatory strategies for addressing problems before they become the kind of business practice that exams typically seek to uncover.

In fact, the most important improvements in market regulation are likely to come from regulators utilizing modern data analysis techniques to identify significant problems early. We believe financial analysis, which complements financial exams by analyzing the current financial condition of significant insurers using real-time data, can serve as the model for making market regulation more timely and effective. There is a broad range of information available for market analysts to use in improving regulatory efficiency.

I note that the Insurance Marketplace Standards Association (IMSA) is represented on today's panel. I want to take a moment to applaud the work of this organization in promoting self audits by life insurance companies. These self audits are not a substitute for regulatory oversight, but they do provide invaluable information that, if shared with regulators, can and should play a significant role in market analysis. Financial analysts routinely review the work of independent auditors to make decisions about regulatory priorities and there is no reason that market analysts can't do the same thing.

Effective use of market analysis techniques, such as enhanced data sharing and interpretation, can also help achieve coordinated state regulatory action with substantially less redundancy and cost. The relationship between market analysis and interstate collaboration is an important one. Effective data collection and analysis can help individual states better target their regulatory resources, but it also can facilitate better collaboration among the states. As states build a common knowledge base and engage in more coordinated monitoring efforts, there will be more opportunities to pursue collaborative enforcement of consumer protection laws. I will discuss some of those collaborative efforts in the next section, but let me first reinforce my earlier comment that the collaborative model on the market regulation side cannot be as easy and simple as the model of domestic deference on the financial side. There clearly are cases where states can rely on each other, but there also are limits to that reliance rooted in differences in state laws, as well as local variations in company behavior.

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

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

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

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

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

Update on NAIC's Market Regulation Reform Initiatives

While recognizing the inherent strength of our state-based system when it comes to protecting consumers, we also agree that there is a need to improve the efficiency of the system. The 2003 NAIC market regulation reform initiatives include market analysis techniques, uniform examination procedures and collaborative regulatory efforts. Let me briefly review the six major initiatives currently being pursued by the Market Regulation and Consumer Affairs (D) Committee through the Market Analysis Working Group and the Uniformity Working Group: 1) the market analysis handbook, 2) the market conduct annual statement pilot program, 3) uniformity in examination procedures, 4) investigation standards, and 5) the interstate reciprocity agreement, and 6) collaborative regulatory efforts on specific consumer problems.

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

In 2002, the NAIC completed Phase I of the market analysis handbook, compiling a broad range of potential data resources that might be used for market analysis. During 2003, the NAIC is completing Phase II of the market analysis guide, which will focus on how states can use three key data sources to target the most significant market problems: 1) complaint data, 2) relevant financial data and 3) market share information. The working group is currently re-drafting the handbook and will have a revised draft available for comment in June of 2003.

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

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

In 2002, the nine pilot states (CA, IL, MD, MO, NE, OH, OR, PA and WI) began collecting data from life insurers. Most life data has been received; however, data quality issues are arising. The states participating in the pilot project are now working with the companies and data to make sure the data is accurate and complete. Once completed, the states will begin identifying potential problem companies and discussing the appropriate regulatory responses.

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

Uniform exam procedures. The purpose of this project is to achieve uniformity in exam procedures, so that exams will be more efficient and so that states can rely more on each other's findings. A general outline focusing on the following four areas was developed in 2002: 1) exam scheduling, 2) pre-exam planning, 3) core examination procedures and 4) exam reports. Greater uniformity in exam scheduling will enhance the states' ability to coordinate their exam scheduling in ways that minimize duplication and encourage states to cooperate more. Greater uniformity in pre-exam planning will enhance the states' ability to better target problem areas and provide companies with a clearer understanding of what is expected of them. The development of uniform examination procedures will make the exam process more predictable and improve exam consistency across states. Finally, greater uniformity in exam reports will allow all audiences, from examiners to consumers, to better understand and compare exam results

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

Investigation Standards. In 2002, the NAIC developed a list of resources and guidelines for all of the market regulation areas and found that guidelines were lacking for investigations. At the same time, the NAIC recognized that some market issues could be resolved without the initiation of a market conduct examination. Based upon this, the NAIC is developing investigation standards that will be useful when there are one or two issues to address but there does not appear to be a general business practice or overall business issue to address.

The NAIC is gathering investigation techniques from various states and exploring the distinction between investigations and examinations, and when one or the other is most appropriate.

Reciprocity agreement. As work on market analysis, uniform exam procedures, and investigation standards continues, the NAIC also is moving ahead with the broader project of interstate collaboration. This work recognizes that the long term prospects for a more effective and efficient regulatory system depend on more collaboration among the states.

In 2002, five states entered into a reciprocity agreement to prevent duplicative examinations and to share examination information and resources. The member states agreed to forgo routine or "comprehensive" exams performed by another member, but retain the right to conduct an examination of target issues. This concept borrows from financial regulation, where states focus on their domestic insurers and rely on the state of domicile to monitor the financial health of foreign insurers doing business in their state.

The goal for 2003 is to have 15 states sign the reciprocity agreement and better define the baseline responsibilities of the domestic state. Clarity on what is expected of the domestic state is critical to this project, since this will determine the extent to which states can rely on each other. It seems clear that any reciprocity model on the market regulation side will have to allow for targeted action by other states, but the extent to which states will feel compelled to take such targeted action will depend heavily on how effectively baseline responsibilities can be defined and implemented. Those baseline responsibilities are likely to involve a combination of market analysis and examination functions.

Collaborative action. While the details of the reciprocity agreement are being hammered out, the NAIC also is moving forward with specific collaborative projects on regulatory problems of common concern to the states. This project is a key priority for the Market Analysis Working Group (MAWG), which serves as a central clearinghouse for discussing and prioritizing common problems. Through the use of MAWG, states will become more proactive in their market regulatory efforts. In addition, the use of MAWG will enhance the coordination of state regulatory efforts and reduce the redundancy of regulatory efforts.

MAWG is in the process of coordinating several regulatory efforts. Because these are formal regulatory efforts, specific company names cannot be released at this time. As the year progresses, MAWG will release as much information as possible in order to explain how certain efforts were modified and better coordinated because of MAWG.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand that modernization of state market regulation efforts is needed to ease regulatory compliance for insurers and agents.

We ask Congress and our industry and consumer stakeholders to work with us to implement the NAIC's modernization initiatives through the state system. That is the only practical way to achieve necessary changes quickly in a manner that preserves state consumer protections expected by the public. The state process may take more effort than some would like, but it rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its members have cooperated fully over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have demonstrated that local and regional state regulation of insurance is the best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

Thank you for your attention and I'd be happy to answer any questions.

APPENDIX A

UPDATE ON NAIC MARKET REGULATION REFORM INITIATIVES

Consumer Complaint Handling

Many consumers only contact with a state insurance department will be the consumer services division after the cancellation of an insurance policy or denial of a claim. In 2001, state regulators handled approximately 3.5 million consumer inquiries and complaints regarding the content of their policies or their treatment by insurance companies and agents. This on-going communication with consumers at a local level is one of the many facets that make state insurance regulation so effective and important. In June of 2001, the NAIC adopted the Consumer Complaints White Paper to help ensure consumer assistance was kept at a high level of effectiveness and to enhance this level of assistance where appropriate.

It is also important to recognize states do not process complaints in an isolated manner. Using uniform data codes, states centrally report complaint information to the NAIC's Complaint Database System (CDS), which has been operational since 1991. This system contains over two million complaints and provides a rich source of information to help states better monitor their marketplace, target their resources and respond to consumers. In addition to the CDS, the NAIC's Consumer Information Source (CIS) allows consumers to view a variety of information about insurance companies and to centrally file a complaint against an insurance company or producer. Through these systems, state insurance department are able to maintain local control and oversight with national coordination and cooperation with other states.

Producer Licensing

In response to the passage of the Gramm-Leach-Bliley Act (GLBA) and the potential creation of the National Association of Registered Agents and Brokers (NARAB), the NAIC focused its attention on satisfying the licensing reciprocity mandates of GLBA. If a majority of states had failed to enact uniform laws and regulations or enact a system of reciprocal licensing by November 12, 2002, NARAB would have been established to provide a mechanism through which uniform licensing, appointment, continuing education and other insurance producer sales qualification requirements and conditions would have been adopted and applied on a multi-state basis. With 36 states certified as having implemented licensing reciprocity as of November 12, 2002, the NAIC exceeded the federal mandates. Today, the number of states certified as having met the licensing reciprocity mandates is 39.

Even though state regulators exceeded the licensing reciprocity mandates, the states continue to view licensing reciprocity as an interim step with the ultimate goal of licensing uniformity. In December of 2002, state insurance departments continued to pursue their commitment to uniform licensing standards by adopting uniform licensing standards for the following areas: 1) licensing qualifications, 2) pre-licensing education training, 3) producer licensing testing, 4) integrity/personal qualifications/background checks, 5) application for license/license structure, 6) appointment process, 7) continuing education requirements, and 8) limited lines licensing.

Tied to these uniform business standards is the electronic enhancements provided through the NAIC's affiliate, the National Producer Insurance Registry (NIPR). NIPR has helped establish a national Producer Database (PDB). The PDB is a central repository of producer licensing information updated on a timely basis by participating state insurance departments. Information on more than 2.9 million producers can be found on the PDB. In addition to this database, NIPR is helping establish a system of centralized, electronic licensing.

State insurance departments have not only met the federal licensing reciprocity mandates of GLBA, they have exceeded this standard by keeping their promise to pursue uniform licensing standards and the use of electronic technology to make producer licensing more effective and efficient.

Rates & Forms

Insurance is regulated because it is a business that is in essence selling a promise to the public that it will be there in time of need to act on its promises. Since the customer receives an intangible product that requires the utmost trust and good faith, state insurance regulators have traditionally been called upon to monitor the financial performance of insurers and to monitor how insurers treat their policyholders and claimants. An important element of market regulation is the review of rates and policy forms. State insurance regulators have dedicated staff to read insurance contracts to see if they comply with applicable state and federal laws because we know that many consumers do not choose to read their policies until they are ready to submit a claim. If a consumer has a problem with the contract language, it is generally too late once the claim has occurred. States also have staff that are asked to review insurance rating systems to make sure that insurance rates are not excessive, inadequate or unfairly discriminatory and to assure that premiums are reasonable in relationship to the benefits provided.

As insurance has evolved it has become apparent that traditional methods of insurance regulation need to be modernized if the insurance industry is to keep pace with its competitors and if insurance regulators are to adequately serve the interests of insurance consumers. It is the area of insurance regulation known as product compliance that is the subject of the NAIC's Speed to Market Initiative. The Speed to Market Initiative is a voluntary undertaking by state insurance regulators to improve the timeliness and quality of the reviews given to insurer filings of insurance products and their corresponding advertising and rating systems. Insurers have been critical of the time it takes for them to get products to market, in part because they must file many of these products with state insurance regulators. While the filing and review process is an important element of consumer protection, it is incumbent upon states to react to insurer filings in a timely and expedient fashion.

The NAIC's Speed to Market Working Group was formed in March 2000 to evaluate insurer's contentions that the state-based insurance regulatory system places them at a competitive disadvantage with other financial services sectors because it takes too long for insurers to bring new products to market. The task facing the Speed to Market Working Group was to decide how multi-state regulatory processes and procedures might be integrated with individual state regulatory requirements to provide a timely and responsive regulatory environment for insurers and insurance consumers. In order to keep insurers competitive with other financial service entities and allow consumers to purchase beneficial insurance products, this working group was challenged to find an acceptable combination of timely and quality reviews with appropriate consumer protections.

The working group quickly came to realize that not all insurers were unhappy with state-based regulation and that the motivation for change from different parts of the insurance industry often depended upon whether they faced direct competition from financial institutions and securities firms or not. Further, consumer interests were very wary of any change that might be perceived to lessen consumer protections.

To meet the challenges that they faced, the Speed to Market Working Group developed two distinct proposals. In recognition of the distinct efforts that would be required to implement the two separate solutions, the NAIC, in March 2001, divided the Speed to Market Working Group into two separate working groups. The CARFRA Working Group is now charged with oversight of the CARFRA project that will be described later. The Improvements to State-Based Systems Working Group was asked to oversee implementation of the operational and regulatory framework efficiencies that were identified in the Speed to Market Implementation Plan. Before the work on CARFRA are discussed, it is important to be aware of an NAIC initiative that has been developed to provide an electronic system for submission of rate, policy form and advertising materials. The System for Electronic Rate and Form Filing (SERFF) provides a viable electronic alternative for insurers to meet their rate, policy form and advertising materials filings with state insurance regulators.

The SERFF system grew out of discussions that occurred as early as 1993. There was initially a lot of opposition to the system from the insurance industry because of costs and unfounded fears that the system would provide immediate access to competitively sensitive information. A consortium of states and insurers would not let the idea of developing an electronic filing system die. This unlikely alliance was able to hire a software vendor and assemble the rudimentary beginnings of the SERFF system. A year into the development, the SERFF Consortium decided that the project was too labor intensive and time consuming to continue on a completely voluntary basis. The consortium asked the NAIC to take over the infant system in 1997 and guide its further development.

Today the SERFF system is a robust Internet-Based electronic system that is voluntary for both states and insurers. Over 650 insurers participate on the system. Following a push from the Improvements to State-Based Systems Working Group that will be discussed later, there are currently 49 states and the District of Columbia participating in

SERFF. Only Rhode Island has not implemented SERFF, in large part for fiscal reasons. Last year 25,530 filings were processed through SERFF with an average turnaround time of 23 days. More than 57% of the filings were completed with 15 days or less offering true speed to market for the nation's insurers. The NAIC is confident that SERFF offers insurers a way to effectively communicate with insurance regulators in a managed environment that enhances the speed, accuracy and consistency of filing review. The SERFF system will be mentioned in regard to CARFRA and the improvements to state-based systems initiative.

CARFRA & The Interstate Compact

The first proposal is intended to address concerns about direct competition with other financial services sector companies. The Speed to Market Working Group recommended the development of a system featuring a single point of filing and review, national standards for insurance products, and an efficient state-based procedure for processing the filing. The CARFRA Working Group has assumed the development of this single point of filing process.

The Coordinated Advertising, Rate and Form Review Authority (CARFRA) process began in May 2001 with a limited launch that initially focused on life and health products. It is the life insurers that are most directly affected by competition from other sectors providing investment type products. The working group believes that CARFRA can also benefit certain property and casualty products and will expand the process accordingly in the future.

The limited launch of CARFRA meets consumers' needs by speeding new products to market while maintaining appropriate regulatory standards of review. CARFRA gives insurers a single point of entry to submit products for review, with the certainty that a filing can be approved for multiple state use within an established number of days.

CARFRA will not require states to slow down or regress in their current processes. For instance, if a participating state is a file and use state, a CARFRA filing can be used immediately in that state upon filing. CARFRA can accommodate a variety of regulatory approaches, not just prior approval.

The limited launch of CARFRA began its part of the regulatory re-engineering process on May 1, 2001. Starting with a focus on life and health products, the limited launch allows insurers to make one filing that will be reviewed based on a set of national standards, together with certifications to state deviations, and receive action from each participating state within 45 days of filing. Future plans call for a 30-day turnaround time.

To date CARFRA has provided valuable information to regulators and insurers. While, it has not been successful from a filing volume standpoint, insurance regulators know that a cooperative review process can work. Due diligence to discover why more insurers have not chosen to use CARFRA led to the conclusion that the state law variations was the most significant stumbling block. Regulators now believe there is a way to develop a more efficient review process for life insurance and annuity products—one that will help insurers better compete in the marketplace while maintaining a high level of protection for insurance consumers. Regulators feel that the best way to accomplish this is through the creation of an interstate compact. In March 2002, the NAIC established the Interstate Compact Working Group to accomplish this goal—to create a national, state-based system of insurance regulation that would provide for uniform standards and a single point of filing for several lines of insurance. The working group drafted a proposed interstate compact will have the flexibility to include life insurance, annuities, disability income and possibly long-term care products. This compact is now known as the Interstate Insurance Product Regulation Compact and this will replace the CARFRA Project once it is implemented.

The work on the drafting of the interstate compact is complete, however, the hard work on implementation has just begun. The NAIC recognizes that a broad base of support is critical. State insurance regulators have been working extensively with their legislative counterparts at the National Conference of State Legislators (NCSL) and the National Conference of Insurance Legislators (NCOIL) to make the compact proposal a reality. In addition, another NAIC working group has been appointed to work on national standards for the compact. This work is underway and preliminary recommendations on a few products are expected to be announced in June 2003.

The second proposal was initially developed by the Improvements to State-Based Systems Working Group. They and focused on operational efficiencies and regulatory framework improvements that can be made to current state-based regulatory systems for product review. It is this working group that developed and adopted a streamlined model rating law urging states to relax filing requirements for commercial lines insurance products. In addition the working group has accomplished many successes since its formation. Included are:

§ Finished the Review Standards Checklist formats for both Property and Casualty and Life and Health product filings. These have now been adopted in 44 states providing insurers with streamlined access to filing requirements thereby improving speed to market for those insurers that choose to use them.

§ Developed the Product Requirements Locator for property and casualty products that will allow insurance companies to query a searchable database by product, requirement, or by state to determine what each state requires when developing a product. Twelve states have implemented this feature with another ten working on adding their product filing requirements. Work on a comparable product locator for life insurance and health insurance products is underway.

§ Completed the work on Uniform Product Coding for both property and casualty and life and health. This allows companies to use common product names and codes for filings in all states.

§ Developed the uniform transmittal forms for product filings for both property and casualty and life and health. This will eliminate companies having to use different transmittal forms when making multi-state filings.

§ Developed measurement tools for determining turnaround time on filings.

§ Implemented numerous enhancements to the System for Electronic Rate and Form Filings (SERFF), including Electronic Funds Transfer (EFT), enhanced navigation and search features, and the ability to track paper filings and metrics.

Market Analysis

Market analysis can provide important tools for monitoring the broader marketplace so that problems can be identified and addressed at an early stage and exam resources can be targeted on the most serious problems. Market analysis tools could include everything from simple surveys on high priority issues to market conduct annual statements, analogous to the financial annual statement that is a bedrock of financial regulation. All states currently engage in at least some types of market analysis, if only to address pressing problems and choose companies for examination. At the most rigorous level, a market analysis program could provide states with the tools to: 1) consolidate data sources into one central system, 2) establish industry-wide benchmarks, and 3) systematically identify problem companies falling outside established benchmarks. At a simpler level, market analysis could provide all states with some rudimentary tools, such as complaint trending analysis that some states already use effectively to identify and address the most serious problems in their marketplace. Throughout 2002, the NAIC further refined the goals of market analysis by focusing on the following two projects: 1) a market analysis handbook and 2) a market conduct annual statement.

The purpose of the Market Analysis Handbook is to identify data and information that is already available to regulators and compile ways this data can be used. This data and information, if used correctly and uniformly, can assist states in identifying possible predictors of potential problems, assist states in using their resources better, and assist states in developing a more detailed understanding of the marketplace. In 2002, the NAIC completed Phase I of the market analysis handbook, which lists potential data resources that might be used for market analysis. During 2003, the NAIC is moving into Phase II of the market analysis guide, which will focus on how states may use the following three sources of data to target the most significant market problems: 1) complaint data, 2) relevant financial data and 3) market share information. The working group is currently re-drafting the handbook and will have a revised draft available for comment in June of 2003.

The annual statement is a market analysis tool that all states can use to review market activity of the entire insurance marketplace in a consistent manner and to identify companies whose practices are outside normal ranges. This will be a tool to help states more effectively target market conduct exams. By using common data and analysis, states will have a uniform method of comparing companies' performance not only within their respective states but also across the various states, providing enhanced opportunities for coordinating market conduct exams. This increased analysis, targeting and coordination will result in fewer duplicative exams. As the statement develops, states may be able to reduce the number of state-specific data calls. States will collect data about claims, non-renewals and cancellations, replacement-related activity and complaints on an industry-wide basis. The information will be collected for personal lines, life and annuity products. If a company's performance appears to be unusual as compared to the industry, the state will want to undertake further review of that company. The additional review may be as simple as calling the company for further information or clarification or conducting further analysis.

In 2002, the pilot states began collecting data from life insurers. Most life data has been received; however, data quality issues are arising. The states participating in the pilot project are now working with the companies and data to make sure the data is accurate and complete. Once completed, the states will begin identifying potential problem companies and discussing the appropriate regulatory responses. The pilot states will also begin working with P&C insurers. P&C insurers are required to submit data for the period of January 1, 2003 through June 30, 2003 by Sept. 1, 2003. Assuming there are no data quality issues, the pilot states will complete their analysis of the data by November 1, 2003. During the NAIC 2003 Winter National Meeting, the pilot states will discuss their results for the property and casualty industry, identify common companies of concern and propose coordinated responses where appropriate.

As the market analysis process is further refined and formalized, the NAIC's Market Analysis Working Group (MAWG), analogous to the Financial Analysis Working Group, will serve as a central clearing point for the prioritization and resolution of issues. Through the use of MAWG, states will become more proactive in their market regulatory efforts. In addition, the use of MAWG will enhance the coordination of state regulatory efforts and reduce the redundancy of regulatory efforts.

Market Conduct Examinations

A market conduct examination is conducted to: 1) ensure equitable treatment of policyholders; 2) determine compliance with the statutes and regulations of a state; and 3) actively monitor the insurance marketplace. While serving a general purpose of monitoring the insurance industry in a state, market conduct examinations also serve as a preventative measure by identifying areas where an insurer should make improvements. Poor market practices and poor management may eventually lead to the financial insolvency of an insurer. Market conduct examinations also serve to verify policyholders and beneficiaries receive the full benefits from the contracts into which they have entered. Through the process of a market conduct examination, an insurance department is able to identify potential problem areas as soon as possible in order to protect the consumers of the state. Initially, each state must thoroughly assess and analyze its market and then attempt to dedicate adequate resources to the market conduct examination process. As regional markets differ, so must the approach to the examination process.

In March of 2003, the NAIC adopted the Market Conduct Examination Resource Guidelines to provide states with various suggestions they may wish to consider after a market assessment has been conducted. This document is divided into the following four sections: 1) description of the market conduct examination function, 2) laws and regulations that support the market conduct examination function, 3) computer and other technical resources that support the market conduct examination function, and 4) areas of expertise and other personnel resources that support the market conduct examination function.

In addition to addressing market conduct examination resources in 2002, the NAIC developed a uniform market conduct examination outline focusing on the following four areas: 1) exam scheduling, 2) pre-exam planning, 3) core examination procedures and 4) exam reports. Greater uniformity in exam scheduling will enhance the states' ability to coordinate their exam scheduling in ways that minimize duplication and encourage states to cooperate more. Greater uniformity in pre-exam planning will enhance the states' ability to better target problem areas and provide companies with a clearer understanding of what is expected of them. The development of uniform examination procedures will make the exam process more predictable and improve exam consistency across states. Finally, greater uniformity in exam reports will allow all audiences, from examiners to consumers, to better understand and compare exam results. Forty of the fifty-five jurisdictions have self-certified compliance with two of the four uniform examination areas in 2002. The states are continuing to work on implementing the uniform examination standards.

Greater uniformity should enhance the states' ability to participate in collaborative regulatory efforts. In 2002, five states entered into a Reciprocity Agreement to prevent duplicative examinations and to share examination information and resources. The member states agreed to forgo routine or "comprehensive" exams performed by another member, but retained the right to conduct an examination of target issues. This concept borrows from financial regulation, where states focus on their domestic insurers and rely on the state of domicile to monitor the financial health of foreign insurers doing business in their state. The NAIC continues to work with states to become a part of the reciprocity agreement by improving the states' ability to consider other state regulatory activities, while retaining their own ability to regulate. A key issue to be resolved is determining what the "baseline" monitoring or examination responsibilities should be for the domestic regulator.

The NAIC's Exam Tracking System (ETS) is used to facilitate automated examination calls and provide centralized examination results. This system has been has been operational since 1985 and contains information for both current and closed financial, market conduct and combined examinations.

In 2002, the NAIC modified ETS to provide a better tool for examination coordination and uniformity efforts. Phase I modifications, which consisted of more automated methods of calling examinations and ensuring the ETS features were tied to the NAIC *Market Conduct Examiners Handbook*, were released in January of 2003. Additionally, four Personal Information Capture System (PICS) reports were created to notify examiners of specific company examinations when they are input into the system. Phase II will consist of the following changes: 1) the market findings screen will be modified to correlate with the handbook, 2) development of market jumpstart reports, and 3) generation of group historical data reports. Phase II is scheduled for release in May of 2003.

Investigations

In 2002, the NAIC developed a list of resources and guidelines for all of the market regulation areas and found that guidelines were lacking for investigations. At the same time, the NAIC recognized that some market issues could be resolved without the initiation of a market conduct examination. Based upon this, the NAIC is developing more defined investigation standards that will be useful when there are one or two issues to address, but there does not appear to be a general business practice or overall business issue to address. The NAIC is gathering investigation techniques from various states and exploring the distinction between investigations and examinations.

Enforcement

The uniform market conduct examination outline directs states to devise an enforcement strategy. Pursuant to the outline, an enforcement strategy should differentiate between willful actions and inadvertent ones and consider appropriate administrative resolutions, which could be financial or non-financial. States should also consider a methodology for determining the amounts of fines, based on a host of criteria, including the size of the company, the market share, whether the problems have been corrected, and any host of mitigating or aggravating circumstances. States should also be certain to communicate the basis of any assessed penalty. Beyond this outline, the Market Analysis Working Group is developing enforcement guidelines for regulatory actions that might be coordinated by this working group.

INSURANCE
MARKETPLACE
STANDARDS
ASSOCIATION

Testimony of

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Executive Director

Insurance Marketplace Standards Association

Subcommittee on Oversight and Investigations of the
House Committee on Financial Services
U.S. House of Representatives
Washington, D.C.

May 6, 2003

Testimony of Brian K. Atchinson
Insurance Marketplace Standards Association

Introduction

Good morning, Chairwoman Kelly, Ranking Member Gutierrez and members of the Subcommittee. Thank you for the opportunity to speak to you today on market conduct reform and Increasing the Effectiveness of State Consumer Protections.

I am Brian Atchinson, Executive Director of the Insurance Marketplace Standards Association (IMSA). IMSA is an independent, non-profit membership organization created in 1996 to strengthen consumer trust and confidence in the marketplace for individually-sold life insurance, annuities and long-term care insurance products. We encourage you to visit our website (www.IMSAethics.org) to learn more about IMSA. IMSA members comprise more than 200 of the nation's top insurance companies representing approximately 65 percent of the life insurance policies written in the United States. The IMSA Board of Directors is comprised of chief executive officers from IMSA qualified companies as well as non-insurance industry directors. To attain IMSA qualification, a life insurance company must demonstrate its commitment to high ethical standards through a rigorous independent assessment process to determine the company's compliance with IMSA's Principles and Code of Ethical Market Conduct.

From 1992-1997, I served for five years as Superintendent of the Maine Bureau of Insurance. In 1996, I was President of the National Association of Insurance Commissioners (NAIC). Prior to joining IMSA, I served as an executive officer in the life insurance industry. As a former regulator and company person, my views on market conduct regulation are based upon a number of different vantage points.

The Changing Role of Market Conduct Regulation

Insurance regulation is intended to ensure a healthy, competitive marketplace, protect consumers, and create and maintain public trust and confidence in the insurance industry. The history of market conduct regulation goes back to the early 1970s when the NAIC developed its first handbook for market conduct examinations and did its first market conduct investigation. We've come a long way -- by 2001, the states employed 353 market conduct examiners and 103 contract examiners, 815 Complaint Analysts, and 494 Fraud Investigators. In 2001, departments reported a total of 1,163 market conduct exams and 439 combined financial/market conduct exams.

Yet, because there is little uniformity in the manner in which individual states perform market conduct examinations, the current state-based system of market conduct regulation presents challenges that even many in the regulatory community acknowledge is in need of improvement/updating. State market conduct examinations have been described as being like snowflakes -- no two are alike. Insurance companies often are subject to simultaneous or overlapping market conduct examinations from different states applying different laws and regulations. This lack of uniformity places significant costs and human resource burdens upon insurance companies that translate into higher costs which are ultimately passed on to consumers in the form of higher prices for their products.

Testimony of Brian K. Atchinson
Insurance Marketplace Standards Association

Making Market Conduct Regulation More Efficient

The challenge going forward is to create a uniform system of market conduct oversight that creates greater efficiencies for insurance companies while maintaining appropriate consumer protections.

The NAIC has been working toward uniform regulation for some time. But, unfortunately, the efforts developed since issuance of the NAIC's Statement of Intent over three years ago have not attained substantial improvements in market conduct regulation. The pace of change has been slow and has prompted the industry to promote more efficient and effective alternatives.

Regulators could improve the current system of market conduct regulation in several ways. Today's market conduct examinations tend to focus upon technical instances of noncompliance rather than exploring whether a company has a comprehensive system of policies and procedures in place to address market conduct compliance issues. As a result, many market conduct examinations are conducted with an emphasis upon identifying technical violations without considering the ultimate impact of these infractions upon consumers.

State insurance departments should not view market conduct examination activity as a means to generate revenue for their operations but rather they should be determining whether a company has a system in place to detect and remedy market conduct improprieties before they become widespread. Determining whether an insurer has a sound market conduct and compliance infrastructure in place will allow market conduct regulation to better serve consumer interests.

Response to Market Conduct Challenges

IMSA's mission is primarily to strengthen trust and confidence in the life insurance industry through commitment to high ethical market conduct standards. IMSA qualification also provides a consistent uniform template of market conduct compliance policies and procedures at all IMSA member companies. To become an IMSA-qualified company, an insurer voluntarily undergoes an internal assessment of their existing policies and procedures to determine whether they comply with IMSA standards. They must then successfully complete a review by an independent assessor to qualify for IMSA membership. By undergoing the independent review required to attain IMSA qualification, a company must have in place a comprehensive system of compliance throughout the organization.

Companies that qualify for IMSA membership devote considerable resources to maintaining IMSA's standards. They also are well-positioned to respond quickly and effectively to state market conduct inquiries and to comply swiftly with new federal or state legislative requirements.

Testimony of Brian K. Atchinson
Insurance Marketplace Standards Association

The USA Patriot Act offers a prime example. As you know, this law gives federal authorities much wider latitude in monitoring potential money laundering activities. Recently the media reported that terrorists, drug dealers and other criminals may be using life insurance products to launder money.

With an infrastructure of policies and procedures in place to detect and cure questionable sales practices based on IMSA's principles, IMSA qualified companies are already in a good position to comply with the intent of federal anti-money laundering efforts.

In the last two years, IMSA has gained greater acceptance by regulators and rating agencies. In fact, a small, but growing, number of state insurance departments use IMSA membership as an informational tool when planning and conducting market conduct exams. We applaud these efforts and would like to see more state insurance departments using IMSA information to create greater efficiencies in the market conduct examination process. During a period of time in which state insurance department budgets are under tremendous pressure, we encourage regulators to pursue all available means to leverage increasingly limited market conduct examination resources. The IMSA independent assessment analysis currently encompasses sales, marketing and advertising activities. IMSA can serve as a valuable resource to help state insurance departments allocate their limited resources more effectively.

IMSA continually strives to meet the needs of consumers, companies and the marketplace as a whole by helping its member companies develop and refine an infrastructure of policies and procedures designed not just to detect but to resolve questionable marketing, sales, and distribution practices before they become more widespread.

Consumer protection through market conduct regulation means more than a system of examinations with technical violations. Consumers should be able to expect honesty, fairness and integrity in their insurance transactions. Neither regulators nor companies alone can ensure that the marketplace is always operating in a fair and appropriate manner at all times. Organizations like IMSA, working in conjunction with regulators, can offer invaluable support to reform market conduct regulation and may even offer a blueprint for reform solutions.

Conclusion

The financial services marketplace is becoming increasingly competitive for life insurance companies. To be able to bring products to market and conduct their operations in an efficient manner, the life insurance industry, as represented by IMSA member companies, believes market conduct regulation must be more uniform and efficient. IMSA qualified companies stand as the benchmark for excellence in the life insurance industry and provide a de facto nationwide set of uniform market conduct and compliance standards that can serve as a template for true market regulation reform.

Testimony of Brian K. Atchinson
Insurance Marketplace Standards Association

We, at IMSA, will continue to work with you and the representatives of the NAIC and state insurance departments to explore ways to improve market conduct regulation for the benefit of regulators, insurers and consumers alike. I would like to thank the members of this Subcommittee for examining this crucial topic and for the opportunity to share my perspectives on this important issue.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

For Release on Delivery
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INSURANCE REGULATION

Preliminary Views on States' Oversight of Insurers' Market Behavior

Statement of Richard J. Hillman
Director, Financial Markets and
Community Investment

GAO
Accountability * Integrity * Reliability

GAO-03-738T

Madam Chairwoman and Members of the Subcommittee:

I appreciate the opportunity to provide you with preliminary observations from our work on state insurance regulators' oversight of market activities in the insurance industry. As you know, Chairman Oxley requested that we review the market conduct activities of state insurance regulators. We are nearing completion of this work, and we plan to issue a report on this subject in the near future.

As you requested, this testimony provides information on two important tools state insurance regulators use to oversee the market activities of insurance companies—market analysis and market conduct examinations. Market analysis is generally done in the state insurance departments. It consists of gathering and integrating information about insurance companies' operations in order to monitor market behavior and identify potential problems at an early stage. Market conduct examinations, which are generally done on site, are a review of an insurer's marketplace practices. The examination is an opportunity to verify data provided to the department by the insurer and to confirm that companies' internal controls and operational processes result in compliance with state laws and regulations. My focus today is on (1) the states' use of market analysis and examinations in market regulation, and (2) the effectiveness of the National Association of Insurance Commissioners' (NAIC) efforts to improve these oversight tools and encourage the states to use them.[1]

To address these objectives, we collected data and interviewed officials from nine state insurance departments—Arkansas, California, Indiana, Maryland, Michigan, Missouri, New Mexico, Ohio, and Oregon, and at NAIC's Kansas City Headquarters. We also reviewed NAIC's past and current efforts to improve the market regulation program. We collected and analyzed data from NAIC on all states, including the number of licensed companies in each state, the number and types of examinations conducted, and the resources allocated to these activities. We also asked 40 companies, 20 each from among the largest 300 property and casualty firms (based on direct written premiums) and the largest 300 life

[1]The National Association of Insurance Commissioners is comprised of the insurance commissioners of the 50 states plus the District of Columbia, Puerto Rico, and the United States Territories. The commissioners promulgate model (recommended) laws and regulations for consideration by the states and provide support services for the state insurance departments. NAIC meetings also provide a venue for discussion of issues that are of interest to all.

companies (based on asset size) about their market conduct examination experiences between 1999 and 2001. Most of these companies are national companies, selling in most or all of the states. However, because our sample was not statistically valid, our results cannot be projected to all insurers.

In summary, we found that while all states do some level of market analysis, few states have established formal market analysis programs to maintain a systematic and rigorous overview of companies' market behavior and to more effectively identify problem companies for more detailed review. The way state insurance regulators approach and perform market conduct examinations also varied widely across the states. While NAIC has developed a handbook for market conduct examiners, states are not required to use it, and we found that it is not consistently applied across states. Moreover, the handbook is not intended to provide guidance for some important aspects of market conduct examinations—for example, how often examinations should be performed or what criteria states should use to select companies to examine. We also found that the number of market conduct examiners differed widely among states and that there were no generally accepted standards for training and certifying examiners. These differences make it difficult for states to depend on other states' oversight of market activities. Most of the states that we visited told us that they felt responsible for regulating the behavior of all companies that sold insurance in their state. With anywhere from 900 to 2,000 companies operating within each state, the pool of companies is simply too large for any one insurance department to handle. Attempts to do so are neither efficient nor effective. Moreover, since many states do not coordinate their examinations with other states, some large multistate insurance companies reported being examined by multiple states, while other companies were examined infrequently or never.

We also found that since the mid 1970s, NAIC has taken a variety of steps to improve the consistency and quality of market conduct examinations. However, despite the NAIC's long-standing efforts and some limited successes, progress toward a more effective process has been slow. Recently, NAIC has increased the emphasis it places on market analysis and market conduct examinations as regulatory tools that could improve states' ability to oversee market conduct. With more consistent implementation of routine market analysis, states should be better able to use the resources they already have available to target companies requiring immediate attention. Also, by consistently applying common standards for market conduct examinations, states should be able to rely on regulators in other states for assessments of an insurance company's operations. These improvements should in turn increase the efficiency of the examination process and improve consumer protection by reducing existing overlaps and gaps in regulatory oversight. However, if NAIC cannot convince the various states to adopt and implement common standards for market analysis and examinations, current efforts to strengthen these consumer protection tools are unlikely to result in any fundamental improvement.

While we focus on the states' use of market analysis and market conduct examinations, market regulation includes several other important regulatory tools, including complaint handling and investigation, policy rate and form review, agent and company licensing, and consumer education. Most states have functioning programs addressing each of these four regulatory areas. Ideally, all regulatory tools, including market analysis and market conduct examinations, should work together in an integrated and interrelated way.

Lack of General Agreement on Standards for Market Analysis and Market Conduct Examinations Results in Wide Variations Among States

In the absence of generally accepted standards, individual states decide how they will do market analysis and perform market conduct examinations. While all states do market analysis in some form, few have established formal programs that look at companies in a consistent and routine manner. States also have no generally agreed upon standards for how many examinations to perform, which companies to examine and how often, and what the scope of the examination should be. As a result of the lack of common standards for market analysis and the lack of consistency in the application of the guidelines for examinations, states find it difficult to depend on other states' oversight of companies' market behavior.

Few States Do Systematic and Routine Market Analysis

NAIC and some states have a growing awareness that better market analysis can be a significant tool for monitoring the marketplace behavior of insurance companies and deciding which insurers to examine. All states perform some type of market analysis. In many states, however, it consists largely of monitoring complaints and complaint trends; and reacting to significant issues that arise. Three states that we visited—Missouri, Ohio, and Oregon—have established a proactive market analysis program. These programs for market analysis have established processes for monitoring company behavior to identify trends, companies that vary from the norm (outliers), and potential market conduct problems. In general, an established program would have dedicated staff and protocols for gathering data and conducting analysis at the department offices.

Each of the three states with an analysis process that we visited approached market analysis in a different way. Ohio's program consisted of special data calls to obtain extensive information from selected company files, and using computerized audit tools to analyze specific aspects of companies' operations relative to norms identified by peer analysis and to state law. For example, Ohio did 184 "desk audits" in 2001 using data requested from companies doing business in the state.[2] Missouri relied on routinely collecting market data from all licensed companies. Missouri has developed a market data report that companies submit as a supplement to their annual financial reports. This data is then used to evaluate market trends and conditions, as well as to identify individual companies that were outliers. Oregon's newly established program involved maintaining files on companies in which all available data was collected to facilitate a broad and ongoing review of company behavior. Both Ohio and Oregon told us that their market analysis programs were still in an experimental stage of development.

When properly done, market analysis can allow states to focus attention on the high-risk companies rather than selecting companies for examination based primarily on criteria such as market share, which does not directly correlate to market behavior problems. Missouri officials added that market analysis is not a substitute for market conduct examinations but should interact and be integrated with the examination process.

We Found Variations in the Way States We Visited Performed Examinations

Each state has between 900 and 2,000 licensed insurance companies. Because in general states do not currently depend upon other states' regulation of companies' market behavior, most states feel a responsibility for overseeing all the companies selling in their state.[3] The impossibility of examining so many companies requires regulators to identify and

[2]A desk audit involves a review of company files at the department without physically going to the company.

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

prioritize which companies they will examine. The states we visited used a variety of factors to choose companies for a market conduct examination. The most commonly used factors for choosing from among the companies deemed eligible for a market conduct examination were complaints, market share, and time since the last examination.

Some states chose to do market conduct exams for only a subset of licensed companies, even though other companies could comprise a majority of the insurers selling in the state.[4] For example, of the states we visited, Arkansas focused primarily on domestic companies—that is, on companies chartered in their state. In Arkansas, 245 of 1,668 licensed companies in 2001 were domestic. As a consequence, 1,423 non-domestic companies, or 85 percent of all the companies licensed in Arkansas in 2001, were not examined in Arkansas in spite of the fact that they may or may not have been examined by some other state.

All the states we visited limited the scope of their examinations to customers from within their particular state. That is, examiners looked only at files of state residents. Moreover, most states further limited the scope of their examinations by focusing on only one or a few of a company's area of operations. While some states still do comprehensive market conduct examinations, the trend is to conduct targeted examinations of limited scope and in a specific area of concern. State officials we interviewed indicated that targeted examinations are being used more often because these examinations do not take as long as comprehensive examinations, allowing states to conduct more. Of the 9 states we visited, Arkansas, Missouri, and New Mexico continued to conduct some comprehensive examinations as well as targeted examinations.

Arkansas officials told us that they believed comprehensive examinations were important because such examinations provided the greatest assurance that companies were complying with insurance laws and regulations. According to NAIC, 49 states and the District of Columbia reported performing some market conduct activities in 2001. Of these, 15 completed only targeted examinations, 4 did only comprehensive examinations, and 22 completed some of both types of examination. The

[4]States generally have the authority to do a market conduct examination on any company that sells insurance in the state.

remaining nine did not complete any market conduct examinations in 2001.

The requirements for and level of training for examiners also varied widely among the states. Each of the states we visited provided some type of training for their examiners. However, there are no generally accepted standards for what constitutes adequate training for a market conduct examiner across the states. Several levels of certifications for market conduct examiners are available, but only 2 of the states we visited, Oregon and New Mexico, required their examiners to certify or become certified in a specified period.

States Vary in the Emphasis Given to Market Conduct Examinations

As can be seen in table 1, there is considerable variation in the number of examinations completed in 2001 by the states we visited. Variation in the number of examinations consistent with the size of the insurance market would be expected. However, as shown in the table, the number of examinations completed bore little relationship to the size of the insurance market in each state. This comparison should not necessarily be taken as an indicator of the relative regulatory performance of the nine states we visited, because during another year the ranking of the states could be different. However, together with the variations in how states select companies for examinations and how they do them, this added variability helps further explain why the states may be reluctant to depend on other states to examine companies selling insurance to their citizens.

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

State	Market conduct examinations completed in 2001	Total premium volume in 2001[1] ($ in millions)	Total number of licensed agents and brokers in 2001	Estimated state population in 2001 (in thousands)
California	80	95,368	220,506	34,600
Ohio	5	39,663	154,100	11,390
Michigan	0[2]	37,840	86,739	10,006
Missouri	29	20,656	91,695	5,637
Maryland	26	20,517	72,039	5,386
Indiana	4[3]	19,208	83,277	6,127
Oregon	15	10,750	46,573	3,473
Arkansas	19[4]	6,919	41,268	2,695
New Mexico	8	6,045	28,910	1,831

Sources: State Insurance Departments.
NAIC's 2001 Insurance Department Resources Report.
U.S. Census.

Note: Does not include follow-up exams or desk audits.

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

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

[3]Three of these were multistate examinations.

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

In addition to the variation in examinations completed, some states have dedicated very few resources to market analysis and market conduct examinations. NAIC's 2001 Insurance Department Resources Report does not even break out department staff assigned to market analysis, although financial analysts are separately identified. In addition, 14 states, or 27 percent, did not report having any market conduct examiners on staff, although 4 of the 14 did report using full-time contract examiners. Ten states, or nearly 20 percent of all states, did not report having any market conduct examiners at all.

Interstate Coordination and Communication Is Inconsistent and Infrequent

Our review of the nine states indicated that the practice of sharing examination information with other states, when it occurred, varied substantially from state to state. Some states coordinate their examination plans with other states or review other states' examination reports prior to going into a company, while other states do not. Even in states where some coordination occurs, other states' examination results do not generally affect examination plans. Oregon officials told us that there is a need for more interstate collaboration and reliance on examination results from other states. More coordination of market conduct examination plans, efforts, and results could improve regulation and, at the same time, reduce the regulatory burden on companies. Many insurance companies, particularly the largest ones, report that they undergo frequent, sometimes simultaneous, market conduct examinations. We asked 40 of the largest national insurance companies to provide information about their market conduct examination experience for the years 1999 to 2001. Of the 25 companies that responded, 19 were examined a total of 130 times by multiple insurance regulators during the 3-year period. Six were examined once or twice during the period, and just over half the responding companies were examined between one and five times. However, three companies were each examined 17 or more times during the 3 years, with one company receiving 20 examinations—an average of seven nearly every year.[5]

These results appear to be consistent with concerns expressed by the insurance industry about excessively frequent and possibly duplicative market conduct examinations. One of the most common complaints from the 25 insurers that responded to our questionnaire was that states did not coordinate their examinations with other states. Some companies reported that, on occasion, multiple states had conducted on-site examinations at the same time. The companies told us that such examinations create difficulties for them and limited the resources they had available to assist the examiners. For example, one insurer wrote, "It takes an insurer a tremendous amount of effort to prepare for and deal with individual state insurance department's exams (every one is different, plus states generally do not accept others exams in place of another similar exam being done). The duplication of effort is wasteful by the states."

In contrast, six companies, or nearly one-quarter of those responding, had not been examined by any state during the period. Of these six companies, two were last examined in 1997 and the other four did not report having any market conduct examinations. These companies—like others that reported—are large multi-state insurance companies. Since in many states a primary criterion for selecting a company for examination is market share, these responses suggest that the proportion of medium-size and small insurers that rarely, if ever, receive a market conduct examination may be much higher.

[5]We did not verify the companies' responses with state regulators. Moreover, we have no basis for evaluating the states' reasons for selecting specific companies to examine.

Groups of states, as well as NAIC, have taken actions to improve the coordination and efficiency of the market conduct examination process. One effort involves improving the sharing of examination information by providing notice of upcoming examinations and sharing results through NAIC's Examination Tracking System. However, the Examination Tracking System is incomplete and often ignored by the state regulators, in part, because it has been inconvenient and difficult to use for scheduling and reporting the results of market conduct examinations. As a result, states are not fully utilizing the system. NAIC's survey of states' use of the Examination Tracking System concluded that no more than 66 percent of the states, or 36 states, consistently reported their market conduct or combined market conduct/financial examination schedules to NAIC. Moreover, only 31 percent of the states reported back to NAIC when the examination had been completed.

Another avenue of coordination being pursued by NAIC and some states is joint, or collaborative, examinations. Based on our review of nine states and of NAIC information, some states do conduct collaborative examinations. For example, Ohio officials told us that they had started to conduct collaborative examinations with Illinois, Nebraska, and Oregon. Indiana officials indicated that they had recently completed an examination of a large insurer jointly with another state. Such efforts, however, have not been consistent among states, nor is there a policy or standard procedure about when or how such examinations should occur. Furthermore, while collaborative examinations could reduce the total number of duplicative exams and may result in somewhat more efficient use of regulatory resources, they still require that each state send examiners into the company. In effect, collaborative examinations are a way for multiple states to do a market conduct examination of a company at the same time. Such an examination may be to the benefit of the company. However, if each state's examiners still ask for samples of files for only their own state's insurance consumers, the benefit may be reduced.

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

The NAIC identified the need for uniformity in market conduct regulation as early as the 1970s. Since then NAIC has launched a number of market conduct efforts intended to identify and address the issues and concerns caused by the lack of uniformity in states' market conduct examination processes, and more recently in the market analysis area. Although progress has been slow in establishing more uniformity in market conduct regulation, NAIC has had some successes. One of the earliest was the development of the market conduct examination handbook containing guidance on conducting and reporting examination results. In general, most states use the handbook as an examination guide, but they can still choose not to follow the handbook in an examination or to modify it. For example, although the handbook lays out the steps for conducting an exam, such as notice of an exam, use of sampling techniques, and preparation of an examination report, each state can go about those steps differently. Moreover, the handbook in not intended to cover some aspects of examinations, including examination frequency and company selection criteria.

One challenge to establishing voluntary uniform national standards for examinations and examination processes is that states are free to adopt the NAIC's model laws, regulations, and procedures; to modify them to meet their perceived needs and conditions; or even to ignore them entirely. Once NAIC as an organization agrees on recommendations that would create more uniform regulatory statutes, two additional challenges to uniformity remain. First, when proposed changes affect state law, state legislatures must approve the recommendations without significant changes. Second, each state insurance department must successfully implement the recommendations. These challenges to establishing voluntary uniform national standards for examinations can clearly be seen in the number of states adopting the model laws and regulation that NAIC identified in 1995 as the essential elements for a market conduct examination program. By 2003, only nine models had been adopted by more than half the states, while two models had been adopted by five or fewer states.

Achieving uniformity in market regulation will be a difficult process for NAIC and the states. However, a similar problem that existed in solvency regulation over a decade ago was solved by creating the Financial Regulation Standards and Accreditation Program. The program's overall goal was to achieve a consistent, state-based system of solvency regulation throughout the country. The program was designed to make monitoring and regulating the solvency of multistate insurance companies more consistent by ensuring that states adopt and adhere to agreed-upon standards, which establish the basic recommended practices for an effective regulatory department. To be accredited, states had to show that they had adopted specific solvency laws and regulations that protected insurance consumers, established defined financial analysis and examination processes, and used appropriate organizational and personnel practices. While the quality of regulation is still not consistent, the Accreditation Program has improved financial regulation across the states. As a result, states are now willing, in most cases, to depend on the solvency regulation of other states.

While the process used by state insurance regulators to oversee solvency could provide a model for oversight of market conduct as well, there are structural differences in market regulation that will undoubtedly affect the ultimate design of an improved market conduct oversight system. These differences will have to be addressed by NAIC and the states in order to move forward. First, market conduct oversight involves many different activities and operations of insurance companies. This fact has broad implications for regulatory consistency and mutual dependence, including requirements for the necessary training of market conduct examiners and analysts.

Second, regulators told us that life insurers tend to use a company-wide business plan and organizational structure. That is, a life company's operations tend to be relatively consistent across the entire company. Property-casualty insurers, on the other hand, tend to use a regional business model and organizational structure. As a result, a property-casualty insurer's operations could differ, perhaps substantially, from region to region. Clearly, the life insurer model is more directly amenable to domiciliary-state oversight than the property-casualty model. However, any regional or state-by-state variances in a company's operations and procedures would reduce the effectiveness of domiciliary-state oversight. Some aspects of market conduct oversight will always be state (or region) specific because of the differences between life and property-casualty insurers, but also because there will always be differences between some of the specific laws and requirements of individual states. As a result, even when greater uniformity of regulatory oversight is achieved, it is likely that states will always have to devote some attention to the activities of insurers not domiciled in their state. Nevertheless, if a state insurance department knew that the domiciliary state was doing consistent market oversight on the company with agreed-upon processes, appropriate scope, and well-trained examiners and analysts, the level of attention needed, even for a property-casualty company, could be substantially lessened. Finally, even to the extent that properly designed and competently performed market conduct oversight can effectively monitor and regulate insurance company practices, it will extend to the sales practices of insurance agents only to the extent that the company takes responsibility for and exercises control of the behavior of the agents that sell its products.

Preliminary Observations

In the current environment of market regulation, most insurance regulators believe they need to oversee the market behavior of all companies selling insurance in their state because they cannot depend on the oversight of the other states. State regulators think this way in part because important elements of market regulation are characterized by a lack of even the most fundamental consistency. Formal and rigorous market analysis is in its infancy among state regulators, and whether, when, and how states do market conduct examinations vary widely. As a result, state regulators are now using the resources that they have in the area of market analysis and examinations inefficiently. Regulators from different states examine some insurers often, while other insurers are examined infrequently or not at all. More importantly, because market analysis is weak, regulators may not be finding and focusing on the companies that most need to have an examination.

We support the goal of increasing the effectiveness of market conduct regulation through the development and implementation of consistent, nationwide standards for market analysis and market conduct examinations across the states in order to better protect insurance consumers. The emphasis placed on these issues by NAIC has increased substantially over the last 3 years. We believe that NAIC has taken a first step in the right direction. Much work, however, remains, as NAIC and the states have not yet identified or reached agreement on appropriate laws, regulations, processes, and resource requirements that will support the goal of an effective, uniform market oversight program. Such a program, consisting of strong market analysis and effective market conduct examinations, will facilitate the development of an atmosphere of increasing trust among the states. However, at present it remains uncertain whether the NAIC and the states can agree on and implement a program that will accomplish this goal.

Madam Chairwoman, this concludes my statement. I would be pleased to answer any questions you or other members of the subcommittee may have at this time.

STATEMENT OF
J. ROBERT HUNTER, FCAS, MAAA
DIRECTOR OF INSURANCE

INCREASING THE EFFECTIVENESS OF
STATE CONSUMER PROTECTIONS

THE SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
OF THE COMMITTEE ON FINANCIAL SERVICES

MAY 6, 2003

Good Afternoon, Madame Chair and members of the Subcommittee. I appreciate the invitation to appear before you again.

Your hearing, "Increasing the Effectiveness of State Consumer Protections," is welcome, even overdue. There is no doubt that there is a great need to increase the effectiveness of state consumer protections and market conduct examination procedures. The efficiency of such exams should also be of interest to the Subcommittee.

The NAIC understands the importance of this issue for consumers. In its "Statement of Intent: The Future of Insurance Regulation", March 13, 2000, the NAIC declared, in the first sentence of that important document that:

> Our primary goal is to protect insurance consumers, which we must do proactively and aggressively.

The Statement went on to say:

> Market conduct is an essential regulatory tool. Its importance to regulators, producers and consumers will increase as the "Speed to Market" reforms are implemented and the marketplace evolves.

However, no one could deny that the state insurance commissioners have a poor record when it comes to market conduct oversight of the insurance industry. Consider the well-known abuses of the major life insurance companies such as Prudential and Met Life in the late 1980s and early 1990s as an example of this failure. Vanishing premiums that did not vanish, life insurance sold to unsuspecting nurses as a retirement plan, replacement of good policies with less valuable policies to gain commission dollars and other abuses hurt millions of people and cost the insurers billions of dollars in verdicts and settlements. Market conduct exams occurred only after legal actions had progressed to the point of proving the seriousness of the problems. Indeed, the New Jersey market exam of Prudential began only when Prudential requested New Jersey to come in as a way to head off more legal problems.

The lack of excellence in market conduct examinations by the states is particularly troubling in an era where less regulation of products is done at the time they are introduced, exposing consumers to greater risk of damage by "bad" insurance policies not reviewed by anyone in the state insurance department.

The unique nature of insurance policies (complex legal documents not easily understood by consumers) and insurance companies (granted anti-trust exemption via the McCarran-Ferguson Act, joint ratemaking/advisory bureaus, etc.) requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guarantee, such beneficial price competition[1].

State systems should be designed to promote beneficial competition – price competition, loss mitigation efforts – and to deter destructive competition – selection competition such as redlining, reverse competition such as credit insurance (where the person selecting the policy, a bank or car dealer, for example, gets a commission and therefore selects high commission rather than low price and then another person pays the premium), other unfair sales practices and unfair claims settlement practices.

<u>Consumer Principles</u>

Consumers believe the reinvention of market conduct standards and exams is the most important work of the NAIC at this time. Therefore this hearing is very timely, Madame Chair. We believe that the following eight items are important to consider as you look for ways to upgrade the State market conduct oversight capacity:

1. High Uniform Market Conduct Standards Can Help Consumers

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[1] Consumers believe the NAIC movement toward deregulation (less front-end regulation) coupled with more back-end regulation (market conduct) is deeply flawed. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and providing proper restitution to consumers after the fact. This is a prescription for more lawsuits.
If more reliance is to be given to a "competitive" system at the front-end, consumers believe that the following must be in place:

- Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees, etc. If consumers cannot adequately compare actual costs and value and if consumers are not given the best rate for which they qualify, there can no true competition.
- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group and other anti-competitive laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies accountable in court for losses suffered as a result of company wrongdoing.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate, such as auto and home insurance. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. "Reverse competition" where the person selecting the insurer may get a commission or other kickback and another party pays the premium must be controlled as well. Standby rate regulation should be available in the event the "competitive model" is dysfunctional.

Minimum standards for market conduct examinations would be good for consumers, if the standards were high and enforced. Consumers have supported minimum national (NAIC) or minimum federal market conduct standards. We agree that consistency in market standards is a good approach but we are very concerned about weak uniform standards. Even with uniformity and strong standards there must be state exceptions, however. For example, it may not be appropriate for every state to require multilingual customer service departments but for some states it may be essential.

2. Use of Accreditation Process

Use of an accreditation-type approach has worked to upgrade state financial examinations. Application of accreditation to market conduct could serve consumers well if the standards for market conduct adopted are high, based on best practices from around the nation. Uniform low standards will not be acceptable to consumers.

3. Enforcement

Standards must include enforcement criteria. For example, if a state has a minimum loss ratio standard for consumer credit insurance in its laws but no company meets the standard, the state has not met its obligation to its consumers.

4. Private Causes of Action

Private causes of action are an important compliment to market conduct exams for two reasons; (1) market conduct exams are prospective and can not grant restitution to already harmed consumers and (2) consumers do not trust the track record of the NAIC and the states to make market conduct systems fully effective to root out corporate misbehavior.

The NAIC is considering whether class action lawsuits somehow undermine their authority to regulate insurance. This is chutzpa of the highest order given the fact that these lawsuits and bad faith lawsuits have easily done more to protect consumers than all of state regulation combined. These lawsuits reveal the weakness of the current State market conduct oversight approach. The lawsuits are not a threat to effective regulation, only a spotlight on ineffective regulation. The states should welcome this assistance given their woeful record on finding serious problems when they undertake market conduct exams.

5. Self-certification has only Limited Application to Insurance

Consumers strongly oppose self-certification programs in the form that some in the industry have proposed. The abysmal record in the area of market conduct by the industry speaks for itself, e.g., redlining, life insurance market conduct abuses, race-based life insurance pricing, numerous claims practice abuses. For regulators to consider a system of handing review over to the industry in any way that would replace part or all of the state process demonstrates a lack of commitment to consumer protection. In the post-Enron era, reliance on self-certification is problematic at best. This is not to say that self-certification could not be part of what a state looks at in determining whether an insurer is meeting state standards. However, if a state relies at all on such information, it must be made public and the tests made by the self-certification group (such as IMSA) must be transparent. We must see when an insurer fails a test and not just be given a seal of approval with no information on what the tests are, how they are scored and the individual insurer's scores. Consumers cannot trust a "black box" system of certification where the substantive results remain beyond public view.

6. Consumer Feedback

Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). Insurers should give consumer notice of this feedback procedure at end of the transaction, e.g., form on-line or toll-free telephone number. This information can feed into the market conduct exam process and help focus the examiners on the trouble spots as consumers see them.

7. Suitability

Suitability or appropriateness rules should be in place and strictly enforced through the market conduct process, particularly for investment/cash value life insurance policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurers are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.

8. Data needed to Undertake Market Analysis

The NAIC should be collecting or requiring states to collect data sufficient for market analysis. These data should include not only information on market shares, entries, exits and so on but also such information as Zip Code data to see if redlining is occurring, information on third party vendors who impact underwriting and pricing with products such as Credit Scores and CLUE claim reports, and other data needed to test the viability of specific markets within the state.

NAIC Progress on Market Conduct Exams is Spotty

There are Some Advances

The NAIC has been working for many years to upgrade the market conduct examination process. There has been some progress in this regard. The Examination Tracking System (ETS) is a tool by which regulators communicate an upcoming market conduct exam and by which results of exams can be disseminated. Improper marketing, underwriting and sales practices information is shared via the Special Activities Database, the Regulatory Information Retrieval System, the Complaints database and the Producer database. Data for some, but not all, of the market analysis needed is being collected on a trial basis.

Overall Disappointment

The NAIC has failed to achieve either effective examinations or efficient examinations. The insurers have complained about the latter problem, since some insurers have multiple exams covering the same topics. Consumers agree that efficiency must be achieved, given limited state regulatory resources.

The market conduct examination data imply that it takes over 10 years for a the average state to complete any (full or targeted) market conduct exams on its domestic insurers and over 90 years to complete such exams on foreign insurers (See spreadsheet attached). When one considers that there were 714 full market conduct exams completed and there are 3,652 insurers in the nation, that implies that a typical insurer (assuming that states cooperate perfectly and there are no duplications of effort) is reviewed in full once every 5+ years or so, assuming 100% cooperation between the states and no duplication. We know that cooperation is not 100% and there is duplication, so the number of years needed to look at all companies at the current pace of State exams is well over 5 years and likely in the 10 year range.

It is very disappointing that, after years of effort and focus at the NAIC on this issue that the domestic state takes over 10 years to look at all the companies that are based in its jurisdiction and overall a similar number is in place for all exams. The states must upgrade these results significantly.

Further, the NAIC does not seem to be able to uncover major and widespread abuses and obtain prospective reform (much less restitution for past damages, which will likely always requires lawsuits). I mentioned the infamous market conduct abuses in the life insurance industry. A case that seems to cry out for consideration of a market conduct effort is State Farm Mutual Auto. Despite what seems to be strong evidence of a plot called "Performance, Planning & Review" at State Farm which appears to attempt to systematically underpay claimants (documented in the case of State Farm v. Campbell[2]) no market conduct examination to review (and, if proven to exist, end) such practices by this leading insurer has been done to CFA's knowledge.

The NAIC Market Conduct Working Group has been at work to improve these examinations. But there are key things left undone after years of effort. For instance, no examination of what went wrong in the previous exams that resulted in the state exam system not detecting significant wrongdoing that later was uncovered by discovery in a lawsuit. It is hard to improve a system that has not been critically analyzed.

There has not been a decision to obtain critically needed information such as underwriting guidelines (which are used by insurers to decide which risks to write or not write and which also indicate the reasons some persons are sent to higher priced situations such as running mates or tiers). Not has the NAIC begun to collect claims handling guides, a major area of consumer abuse.

Nor has the NAIC called upon the states to obtain required data to test markets and determine if the market is under serving certain consumers. Zip code data, for example, could be used to determine if redlining is occurring by any insurers. Use of these data when I was Texas Insurance Commissioner resulted in insurers agreeing to increase market shares in underserved areas of Houston and Dallas. The NAIC will currently not order such information for use as part of market conduct examinations.

Absent from the working group's work are standards by which to test whether the state's market conduct function is adequate, e.g., resources. There is no use of testing by persons posing as policyholders to determine if insurers are using inappropriate underwriting guidelines, no surveys of policyholders and agents to see how insurers rank in their opinions,

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[2] State Farm Mutual Insurance Company v. Campbell, Et al, US Supreme Court, Slip Opinion, April 7, 2003. In the decision, the Justices called State Farm's claims practices "reprehensible conduct." In her dissent, Justice Ginsberg listed many of these outrageous practices (falsifying and withholding evidence, pressuring claims representatives to pay below fair value, unjustly attacking a claimant and so forth). Details of the practices can be read at length at Campbell v. State Farm Mutual Automobile Insurance Company, Third Judicial District Court of Salt Lake County, State of Utah, August 3, 1998, at paragraphs 29 – 80.

no meaningful suitability requirements in place and no other methods to build up consumer confidence in the market conduct exams.

All information on market conduct exams, including underwriting and claims settlement guides should be posted on the web. Only two states do so according to CFA's last review of state web pages.

Responses to the Subcommittee's Questions

1. *Please describe how the current patchwork State system of market conduct regulation is creating expensive regulatory burdens in some areas, while failing to protect consumers in others by failing to set standards and target resources.*

RESPONSE: While some insurers with good records are subject to repeat exams covering the same areas, the States have failed time and time again to catch the really critical issues that harm consumers, such as market conduct abuses or unfair claims settlement practice abuses. There needs to be a refocus of the exams to upgrade consumer protection.

2. *Please describe how the creation of a systematic approach to market conduct regulation with a focus on market analysis and uniform standards would benefit consumers.*

RESPONSE: Minimum standards for market conduct examinations would be good for consumers, if the standards were high and actually enforced. Consumers have supported minimum national (NAIC) or federal market conduct standards for many years. We agree that consistency in market standards is a good approach but we are very concerned about weak uniform standards. Even with uniformity and strong standards there must be state exceptions, however. For one clear example, it may not be appropriate for every state to require multilingual customer service departments but for some states it may be essential.

3. *Please evaluate current NAIC and NCOIL efforts to develop a more uniform, coordinated, systematic approach to market conduct oversight.*

RESPONSE: See section "NAIC Progress on market conduct exams is spotty."
The new NCOIL proposal, just completed by Price, Waterhouse, as we understand it, has not yet been available for CFA's review. We will comment once we have seen the report.

4. *How critical is it that States adopt and implement objective and written best practices standards for market conduct oversight?*

RESPONSE: In order to achieve high standards, best practices are an excellent approach. Consumers must be at the table as these best practices are reviewed and standards are set. Further, we support an accreditation-type approach to assure that states actually adopt these high standards rather than having them sit on a shelf unused (as often happens with NAIC Model approaches).

5. *How can the States ensure the reliability of coordinated or reciprocal market conduct oversight with proper enforcement criteria?*

RESPONSE: An accreditation program can assure that there will be coordinated/reciprocal efforts by the states in implementing market conduct systems. A private right of action is necessary to test the reliability of any system. The more effective the system, the less use of such actions will be required, except to gain restitution for persons harmed by a practice introduced between exams, something the market conduct exams appear unlikely to ever accomplish.

Appendix A -- CV

J. ROBERT HUNTER

CURRENTLY

- Director of Insurance, Consumer Federation of America (pro-bono)
- Consultant on Public Policy and Actuarial Issues
  (Practice limited to government agencies and consumers)

EXPERIENCE

- Commissioner of Insurance, State of Texas
- President and Founder, National Insurance Consumer Organization (pro-bono)
- `Consultant to Government Agencies and Consumers
  (Clients included federal agencies including HUD, GAO, and EPA as well as states such as CA, FL, GA, MA, ME, NC, NJ, NY, OK SC, TX)
- Federal Insurance Administration, serving as:
  Federal Insurance Administrator
  Deputy Federal Insurance Administrator
  Chief Actuary
- Private Insurance Industry experience, including:
  Associate Actuary, Mutual Insurance Advisory Association and Mutual Insurance Rating Bureau (now AIPSO)
  Actuarial Supervisor, National Bureau of Casualty Underwriters (now ISO)
  Underwriter, Atlantic Mutual and Centennial Insurance Companies

AWARDS

- HUD Secretary's Award for Excellent Service, for work performed from 1971 to 1977
- Esther Peterson Consumer Service Award for lifetime service, CFA, 2002
- Schraeder-Nelson Publications Award; article of the year for Enron's Impact on State Insurance Regulation, Regulator Magazine, Insurance Regulatory Examiner's Society 2002

PUBLICATIONS

Taking the Bite Out of Insurance: Investment Income in Rate making, 1980

Gas Prices and Auto Rates: Insurance Implications of the Dynamic Changes in America's Driving Habits, 1981

Study of the Feasibility of Risk Retention Groups for Hazardous Waste

Worker's Compensation Insurance Rate making: Regulation of Profit Margins and Investment Income, U. S. Department of Labor, co-authored with Professor R. Hill of Princeton University, 1983

Investment Income and Profitability in Property/Casualty Insurance Rate making, NAIC Investment Income Report, co-authored with J. W. Wilson, 1983

Insurance in California: Profitability, Competition and Equity is Selling and Pricing Private Passenger Automobile Insurance and the Crisis in Day-Care and Municipal Liability Insurance, California State Legislature, 1986

Private, Pay-at-the-Pump Auto Insurance, 1992

Studies of the Quality of State Regulation (Brochure Excellence, Complaint Data Quality, Web Page Usefulness, Resource Adequacy), CFA, 1999-2000

NAIC ACTIVITIES

1993-4 Member of NAIC
1993-4 Member, NAIC Executive Committee
1993-4 Vice-Chair, Western Zone of NAIC
1992-3 Funded Consumer Representative to NAIC
Served as advisor to NAIC on several projects dealing with profit, rate making, market conduct and other consumer issues

Consumer Federation
of America

Appendix 2
Data on Market conduct Exams by State

STATE	Number of Domestic Insurers 2001	Domestic Market Coduct Exam completed 01	Years to do all domestic insurers		Number of Foreign Insurers 2001	Foreign Market Coduct Exam completed 01	Years to do all foreign insurers
Alabama	53	16	3.3		1277	1	1277.0
Alaska	8	0	Forever		1063	0	Forever
Arizona	398	7	56.9		1525	124	12.3
Arkansas	74	18	4.1		1464	0	Forever
California	219	74	3.0		1210	74	16.4
Colorado	74	5	14.8		1410	19	74.2
Connecticut	132	14	9.4		1055	27	39.1
Delaware	144	28	5.1		1426	2	713.0
Dist. of Col.	23	0	Forever		1347	0	Forever
Florida	201	28	7.2		1612	68	23.7
Georgia	106	5	21.2		1473	20	73.7
Hawaii	117	3	39.0		926	0	Forever
Idaho	23	6	3.8		1426	1	1426.0
Illinois	446	12	37.2		1469	15	97.9
Indiana	183	1	183.0		1598	2	799.0
Iowa	220	33	6.7		1403	0	Forever
Kansas	57	1	57.0		1642	0	Forever
Kentucky	52	1	52.0		1504	9	167.1
Louisiana	147	20	7.4		1485	12	123.8
Maine	33	0	Forever		925	2	462.5
Maryland	96	12	8.0		1392	40	34.8
Massachusetts	94	11	8.5		1273	50	25.5
Michigan	142	36	3.9		1383	0	Forever
Minnesota	94	4	23.5		1438	0	Forever
Mississippi	70	15	4.7		1428	3	476.0
Missouri	247	6	41.2		1411	42	33.6
Montana	28	0	Forever		1407	0	Forever
Nebraska	113	9	12.6		1440	24	60.0
Nevada	39	7	5.6		1704	12	142.0
New Hampshir	49	2	24.5		859	10	85.9
New Jersey	101	5	20.2		1165	6	194.2
New Mexico	19	5	3.8		1476	3	492.0
New York	505	90	5.6		927	69	13.4
North Carolina	97	9	10.8		1243	30	41.4
North Dakota	42	2	21.0		1378	0	Forever
Ohio	275	27	10.2		1505	11	136.8
Oklahoma	104	28	3.7		1480	9	164.4
Oregon	139	13	10.7		1486	2	743.0
Pennsylvania	313	13	24.1		1404	9	156.0
Rhode Island	33	1	33.0		1210	5	242.0
South Carolina	50	14	3.6		1424	3	474.7
South Dakota	52	0	Forever		1403	3	467.7
Tennessee	111	26	4.3		1559	0	Forever
Texas	512	29	17.7		1529	2	764.5
Utah	45	12	3.8		1423	0	Forever
Vermont	410	0	Forever		937	4	234.3
Virginia	82	23	3.6		1407	35	40.2
Washington	69	3	23.0		1336	11	121.5
West Virginia	20	3	6.7		1304	0	Forever
Wisconsin	355	13	27.3		1536	3	512.0
Wyoming	4	1	4.0		1304	0	Forever
Countrywide	7020	691	10.2		69411	762	91.1
Average	138	14	10.2		1361	15	91.1

Source: 2001 Insurance Department Resources Report, NAIC

NOTES: * California reports 148 completed MC Exams but no breakdown between domestic & foreign. Assigned half of the completed exams to each.

*Includes both Market conduct exams and combineed financial/market conduct exams.

*Of all completed Exams, 714 were routine and 738 were targeted.

* Reliance on other state exams will reduce the years to complete indications, particularly for foreign companies.

Alliance
of American Insurers

Testimony of the
Alliance of American Insurers
to the
Subcommittee on Oversight and Investigations
of the
U.S. House Financial Services Committee
on
"Increasing the Effectiveness of State Consumer Protections"

May 6, 2003

Presented by
Lenore S. Marema, CPCU
Vice President – Legal and Regulatory Affairs
Alliance of American Insurers
Downers Grove, Illinois

Modernization of State Insurance Market Conduct Examinations

The Alliance of American Insurers is a national trade association representing over 340 property-casualty insurance companies doing business nationwide. The Alliance has been actively involved in the market conduct issue since the 1979 McKinzie study recommended that states conduct market conduct exams. In general, the Alliance has supported efforts by the NAIC and the states to improve the examination process, and has supported well-trained and experienced insurance department staff as examiners. The Alliance has also historically been concerned about the costs of market conduct exams and has sought efficiency in the process. The Alliance believes that there are reasonable and practicable steps that all states can take to improve their market conduct regulation. We appreciate the opportunity to present testimony.

The Alliance Perspective on Market Conduct Examinations

On-site market conduct exams are one of the many methods by which state insurance regulators oversee and verify the compliance of insurers with state laws and regulations. Exams are not the only point of contact that insurance regulators have with the entities they regulate. Among many other contacts, state regulators license companies and agents; they have authority to approve the rates and forms that insurers use; all states handle an enormous volume of consumer complaints every year; they receive reports on holding company transactions and must approve significant transactions; and they address developing market conduct problems with regulations under their unfair trade practices and unfair claims settlement practices laws. State insurance regulators also have a wide variety of effective administrative options short of an on-site examination to address potential market conduct problems with insurers ranging from simple informal inquiries to submission of interrogatories to performance of desk audits. The on-site market conduct examination system must be seen in its context of one tool in state regulators' kit. The fact that an insurer has not been examined recently by no means indicates its market behavior has gone unregulated.

In terms of the efficiency and effectiveness of the current state market conduct examination system, Alliance members have several overriding concerns with the market conduct process.

- **Focus on General Business Practices** – One such problem is that examiners focus on documenting and verifying an insurer's compliance with applicable laws and regulations, rather than on its general business practices. For example, an insurer with a very low number of complaints and a very low error ratio upon a sampling of its underwriting or claims files can still be subject to insurance department penalties for failing to exactly document its compliance or for other minor technical or clerical errors.

- **Coordination and Consistency** – Our members also find that there is a lack of coordination among the states regarding scheduling exams and a lack of consistency among the procedures and requests of each state. Some large companies feel that they are examined more frequently, not because they have more problems, but because they represent a large percentage of the market share that the state insurance department needs to examine. A large company can have numerous different state insurance department examinations being conducted at the same time, with each state making different demands for information in different formats. Market conduct exams use an increasing amount of company resources in terms of office space, staff time, and systems time, among other resources.

- **Targeted Exams** – Too many market conduct examinations are still broad and unfocused. The Alliance and the industry in general has constantly urged that states conduct "targeted" examinations, rather than periodic and comprehensive examinations. Many states contend that their examinations are "targeted" when they are actually focused very broadly on "claims" or "underwriting," rather than on specific issues or problems, such as private passenger auto collision claims in 2000 involving the use of aftermarket parts. Exams still need to be more carefully targeted by issue and by company.

- **Fines and Penalties** – A most significant concern is the fines that result from market conduct exams. If the stated purpose of market conduct exams is to improve a company's compliance with state laws and regulations, then the result of an examination should be focused on correcting problems. Insurers should be given an opportunity to correct problems before they are fined.

- **Subjective Factors** – State market conduct examiners often interpret the laws and regulations during the course of an examination. Many times, an examination is the first time an insurance company is informed of insurance department expectations for compliance with a particular law or regulation. As a result, the company has violated the law and is subject to fines.

- **Costs of Exams** – Alliance members have also expressed concern about the cost of market conduct exams in general, and on the increasing use of contract examiners, who substantially increase the cost of examinations. Sometimes an insurer can get a glowing report but the cost is a lengthy exam. Contract examiners tend to exacerbate this problem. Such examiners may not be familiar with the specific state laws and practices, have the incentive to find errors and violations, and will often interpret the statute themselves.

Creating a More Rational Basis for Identifying Problems and Triggering Action

Alliance members often question what triggers a market conduct exam. Some companies feel that states continually examine the large companies in order to report that they have examined a significant portion of the market share in the state. Some Alliance members report that even when market conduct examiners have particular issues on which they are focusing, they tend to examine all or as many companies as possible for that issue, rather than choose specific companies based on potential problems. There are also isolated instances among the Alliance membership of a market conduct examination being initiated for a punitive purpose based on the fact that the insurance department did not like the way the company handled a particular claim or some other legitimate action that the company undertook.

The Alliance believes that there is reliable and useful information about insurers available to all states that would provide a more objective and rational basis for identifying market conduct problems and triggering insurance companies for action. The Alliance believes that the following should be adequate and accurate market conduct triggers that all states could use:

- **Complaint Data** – An effective market conduct process should begin with consumer complaints and inquiries as a compass for state insurance regulators. In the early 1970s, the McKinzie Report on financial and market conduct examinations recommended that market conduct exams should be driven by consumer complaints, and in 1979, the General Accounting Office advocated this same policy. It remains good public policy today. With the consumer in mind, what better way to use limited state insurance department and company resources than to examine companies for the problems that consumers consider most important to them, namely, those for which they have filed a grievance with the state insurance department.

To use complaint information accurately, states will have to put complaints into their proper context. Sheer numbers may be misleading. States will need to look at justified vs. unjustified complaints, and otherwise compare a company's complaints to its policies, premium volume, mix of business and the size of the risks it writes, among other factors. The bottom line, however, is that complaint data should be a primary market conduct indicator that all states can and should use in market conduct regulation.

- **Statutory Page 14 Changes** – Every insurance company files a Statutory Page 14 with each state giving the details of its business in the state. This includes a variety of factors and ratios that should be of key interest to the states in market conduct surveillance. The Alliance believes that key market conduct indicators should be significant changes in the Page 14 ratios, such as changes in the company's overall market share in the state or in specific lines; changes in the loss and expense ratios; and changes in defense costs, among others. A rapid change in any of these indicators by itself does not indicate that a company has a problem, but should signal the regulator that more information should be sought as to the reasons for the changes in the Page 14 data.

- **Changes in Management** – Significant changes in the company's management, through changes in officers and directors or through mergers and acquisitions and other business affiliations may signal changes in company's operations. Again, this does not necessarily indicate market conduct problems. In fact, such changes could be a significant improvement for services and financial stability to the policyholders. Management changes reported on the Annual Statement or in the insurer's holding company registration statements should, however, be one indicator that insurance departments use to seek additional information to detect potential market conduct problems. Management competency is an increasingly important market conduct indicator.

- **Other Significant Company Changes** – Through published reports, the trade press or other sources, regulators are advised of other significant changes in a company, such as a major systems update or consolidation of offices, which may generate errors. Any such major change in a company's operations or facilities could be a market conduct indicator.

These are indicators that are applicable to all lines and all company activities. All states currently receive the above information on a regular basis so it would be a method of market conduct analysis that all states could use right now to provide a more systematic basis for targeting insurers for examination. This type of analysis can also be done within state budget constraints.

Illinois and Ohio use an annual market statement approach. The Illinois Market Conduct Annual Statement covers auto and homeowners and it collects information on claims activity, such as the number of claims open and claims closed, the date of report to date of final payment, the date of accident to date of report, and number of claims in litigation. Illinois also collects the number of agents by zip code. The Ohio Market Conduct Annual Statement is similar to Illinois in that it asks for claims activity and the date of report to the date of final payment. Ohio also asks for claims complaint information. These annual statements are targeted at personal lines, which are of most importance in terms of consumer protection. Alliance members generally report that these states genuinely do use this information to target companies for exams, and that they can produce the data requested, at least after the companies have gained experience after a year or two of collecting and processing the requested information.

If more states were to use a market conduct annual statement, however, consistency is critical in both the data requested and the state usage to trigger further market conduct review. Otherwise, 50 different demands for data would be much more burdensome and costly, particularly when compared to the market conduct indicators listed above that states could easily generate from information already available.

Better data and more sophisticated analysis is always possible, but it always involves additional costs, which are ultimately borne by the insurance consumers. The Alliance believes that the above market conduct indicators are not only reliable, but that they are readily available to all states at no additional cost to regulators or the industry. States should start with these common indicators that they all now have before any other new data source is developed or required. It may be particularly useful to the new NAIC Market Conduct Analysis Working Group to have all states readily able to use the same market conduct triggers right from the start of its work.

Determining an Appropriate Response to Market Conduct Problems

Once the market conduct indicators suggest a potential market problem, the Alliance believes that states should have a menu of possible responses, with an on-site market conduct examination being a last resort. For example, if a company's market share is rapidly increasing, the insurance department should contact the insurer and ask for information regarding its number of licensed sales representatives agents and brokers and its number of licensed adjusters to see if there are proportionate increases in those areas. Similarly, increasing loss and expense ratios should trigger a request for the number of rate and form filings being made, whether informational or not.

States have implemented such market conduct procedures short of an on-site exam. North Carolina, for example, has an interrogatory process that most Alliance members find to be very effective and efficient. Rather than conducting an on-site examination, the North Carolina departments calls or has an informal meeting with a company to discuss potential problems, and sometimes sends interrogatories to the company regarding that problem or to the industry in general regarding the compliance on a particular issue.

States also have found ways to assist insurers with their compliance. Some states routinely publish, on their websites or by way of department bulletins, their priorities for market conduct analysis or market conduct exams. Some states publish a list of the most common or the most serious violations they have found in recent exams. Insurers are willing to learn from others' mistakes and receipt of this kind of information from state insurance departments promotes compliance.

Some departments have issued interpretative guidelines on various laws and regulations. Sometimes this is done after surveying the industry for compliance benchmarks, and other times it is after one or more market conduct examinations when it is apparent that insurance department expectations and insurance company interpretation under state laws are different. Occasionally, insurance departments issue bulletins to publish department opinion or expectations with little input from or industry experience with the matters in question. States that issue such interpretive guidance need to understand that these are not the equivalent of statutes or formal regulations and that such bulletins are not binding on the industry.

The Alliance believes that companies should not be examined until there is a reasonable cause to believe that a violation or specific problems exist within the company. This is particularly true for companies with a small premium volume in the state. To trigger a costly on-site exam when there are no red flags about the company's writing is not the best use of limited resources. There are many other beneficial steps that that states could take, short of an on-site exam, to address market conduct and compliance problems. Many of these steps have already been suggested by the NAIC Market Conduct Working Group in the outline for its paper to improve the state system:

- *Informal inquiry (phone or letter) to confirm identification of department concerns;*
- *Interview or other Informal Review – meeting or call between regulators and insurer to see if the matter can be sufficiently explained and resolved;*
- *Interrogatories to the company for more information;*
- *Interrogatories to the industry, if appropriate, to determine benchmarks for compliance, particularly if a new law is involved;*
- *Industry/Company education—interpretative department bulletins, seminars;*
- *Policies and procedures reviews;*
- *Desk Audits;*
- *Data Calls—Company/Industry;*
- *Targeted Exams (e.g. private passenger auto claims in 2000 involving the use of aftermarket parts);*
- *Investigations;*

- *Comprehensive Exams.*

Developing More Consistency in Market Conduct Examination Procedures

The NAIC has long had a Model Market Conduct Examination Handbook that many states follow. This does not necessarily mean, however, that there is exact uniformity among the states conducting exams according to the procedures in the Handbook. While the Handbook instructs states in the steps in conducting the exam, such as notice of an exam, use of sampling techniques and preparation of an examination report, each state goes about those steps differently. The NAIC Uniformity Working Group has been developing uniform examination procedures for use among the states, and the uniformity document that has been developed is similar to a list of "best practices" for the states.

The Alliance believes that all states should implement most of the recommendations of the NAIC Uniformity Working Group report, but recognizes that not all of this can be done at the same time and all at once. Therefore, the following would be priorities for the Alliance in implementation:

- **Develop a Standardized Data Call** – A standardized list of the data items that states may want to review in an exam would save a significant amount of time and costs. Even if every market conduct examiner only wanted a subset of the whole standardized data call, having a standard template would make the information easier to produce for each exam. For example, if it is determined that there are 45 items that examiners could potentially want to see on a policy edit, an insurer could devise a program that captures all 45, and when a state comes in and only wants to see 10 or 20 of them, insurers would not have to go back and devise a new program each time. They'd just select these 10 or 20 items from their existing program. Such a process would make the information easier and faster to produce for each market conduct exam. The NAIC has developed a standardized data call. Now the modernization will occur when all states conducting market conduct exams use it exclusively.

- **Exam Planning** – As much information as possible about the exam and sufficient lead time is significantly beneficial to Alliance member companies. States that clearly state the parameters of an exam and otherwise plan in advance for it, and communicate that to the company, greatly help both parties in the equation. The company can have the information that market conduct examiners want ready and available when they arrive. It is very important for the states to give companies the projected time frames of the examination advance in order for them to plan for systems and staff time. A projected budget for the exam should also be provided, particularly when a contract examiner will be used.

  Planning helps the regulator as well. Some Alliance members report state insurance department examiners having to wait idly while another state finishes an exam before they can start their own exam. Examiners requesting data and other information for the first time when they are on-site may have to wait for the company to produce it, thus delaying their examination.

The NAIC has developed a Pre-Exam Planning Checklist for this purpose. It is an excellent statement of best practices for the states in planning for an exam. Modernization of the state process will now occur when all states conducting exams implement it.

Many of the recommended practices and processes in the NAIC Uniformity Working Group report mirror what the Alliance and the other trade associations have previously suggested in their 12-point program. A copy of that joint trade statement is attached.

Promoting Compliance and Corrective Action in Enforcement

Fines should not automatically be a result of a market conduct exam. Rather, the focus should be on corrective action and bringing insurers into compliance with the law. The Alliance suggests a graduated response once a company has been examined:

- *Market Conduct Exam;*
- *Procedure to Discuss Findings and Conclusions with the Insurer;*
- *Exam Report;*
- *Issuance of Cease and Desist Order or Order to Come into Compliance With Specified Time Frames;*
- *Later Request of Company to Demonstrate Compliance or Later on-Site Verification of Compliance;*
- *Fines/Penalties for Non-Compliance.*

When ordering corrective action after an exam, some insurance departments impose records keeping requirements, generally intended to assure that the company comes into compliance and better documents its actions. The sum total of multiple states each creating specific procedures and record retention requirements for an insurer can be burdensome. The Alliance believes that insurers need the flexibility to correct problems in a way that it is consistent with company practices and internal systems rather than trying to impose a specific method on the insurer. If a violation has been found and corrective action is needed, the company examined has every incentive to make the necessary changes. All the company usually wants to do is find the most cost efficient way of making the adjustments.

Another issue that arises in connection with determining the appropriate response is how to treat multiple instances of a single error. Some states recognize that a single error can be repeated multiple times if that error becomes incorporated into a company system or procedure. Many states recognize this as a single error or glitch while other states count it as multiple violations. For purposes of a market conduct report and corrective action, these should be counted as single error.

If fines are a result of an exam, what is the proper basis for fines? Generally speaking, departments seem to have two types fines. One type relates to the specific actions of the insurer examined and the nature of the violation. The amount would vary by company. The other type seems to be an automatic fine for certain types of violations, such as failure to submit timely holding company statements, and the fine is the same for every insurer. In the former case, which is more common, Alliance members often do not understand the basis for the fine nor the manner in which the department arrived at the actual dollar amount. The Alliance suggests that state insurance departments implement the following guidelines in imposing fines:

1. *States should have the authority to impose fines if an insurer knowingly and intentionally violated the law/regulations;*

2. *A fine should not automatically result from a market conduct exam. Rather, states should give first notice, require corrective action and permit time for remedial action to take place. If corrective action is not taken, a fine is appropriate. For example, If there is no intentional violation and an insurer acted in a manner reasonably believed to be in compliance with the law, no fine should be forthcoming if the company agrees to take remedial action in the spirit of compliance.*

3. *No fines should be imposed unless the insurance department has previously issued guidance, interpretation or its expectations regarding compliance with the law when the violation revolves around a department interpretation of the statute. Rather, in this case, the insurer should be able to contest the interpretation through the administrative process without penalty or the department should issue a corrective order to the insurer.*

4. *Any fine should reflect the actual harm done to the public; e.g. was the policyholder/claimant hurt by the insurer's conduct?*

5. *State regulators need flexibility in the process to consider mitigating factors when imposing a fine;*

6. *Adequate administrative procedures need to be in place to permit review of fines and penalties.*

A few states have adopted laws or regulations setting forth specific dollar fines for listed violations. The state insurance department is given no authority to consider mitigating circumstances. It makes no difference, for example, if the violation was knowing and intentional or a result of a glitch in a new computer system. Such a law also makes the exam process more contentious as the insurer must dispute the finding of a violation as a fine will be automatic if the violation stands. Dollar amounts set forth in a statute also require continuing legislative change to update them. The Alliance takes no position on the dollar amount of fines and recognizes that the amounts put into a statute will vary by state. If states are inclined to specify dollar amounts for fines, the insurance department still needs to be given authority to consider mitigating circumstances and corrective action should still come before any fine is imposed.

What Needs to Be Done to Modernize the Current State Market Conduct Examination System?

The Alliance believes that there are steps that all states can take to improve market conduct regulation. The Alliance envisions a market conduct process from start to finish that is as follows:

- Targeting companies and specific problems from use of the following indicators:
    - *Consumer complaint data;*
    - *Changes in Page 14 Ratio;*
    - *Changes in company management;*
    - *Other major company changes.*
- Informal inquiry (phone or letter) to confirm identification of department concerns;
- Interview or other Informal Review – meeting or call between regulators and insurer to see if the matter can be sufficiently explained and resolved;
- Interrogatories to the company for more information;
- Interrogatories to the industry, if appropriate, to determine benchmarks for compliance, particularly if a new law is involved;
- Industry/Company education – interpretative department bulletins, seminars;
- Policies and procedures reviews;
- Desk Audits;
- Data Calls – Company/Industry;
- Targeted Exams;
- Investigations;

- Comprehensive Exams;
- Procedure to Discuss Findings and Conclusions with the Insurer;
- Exam Report;
- Issuance of Cease and Desist Order or Order to Come into Compliance With Specified Time Frames;
- Later Request of Company to Demonstrate Compliance or Later on-Site Verification of Compliance;
- Fines/Penalties for Non-Compliance.

The Alliance believes that regardless of a state's current situation regarding market conduct analysis and examinations, there are steps in this suggested continuum that each state can take to improve its process.

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STATEMENT OF THE ALLIANCE of AMERICAN INSURERS AMERICAN INSURANCE ASSOCIATION NATIONAL ADSOCIATION of INDEPENDENT INSURERS NATIONAL ASSOCIATION of MUTUAL INSURANCE COMPANIES

12 POINT PROGRAM TO IMPROVE MARKET CONDUCT EXAMINATION PROCESSES

The Alliance of American Insurers, American Insurance Association, National Association of Independent Insurers and National Association of Mutual Insurance Companies commend the NAIC Market Conduct Issues Working Group for examining ways to improve market conduct examination procedures. This is important work, which the members of all four trade association endorse.

The trade association have discussed with their respective members suggestions and recommendations for improving market conduct examination procedures. As a result of those discussions, the four trade associations have developed a 12 point program for improving these procedures. For the most part this program does not require development or adoption of new model laws or regulations and the 50 state legislative effort such a program would require. It does not require creation of interstate compacts or other regulatory mechanisms that would require either congressional or state legislative activity. Instead, this 12 point program promotes measures which state Insurance Departments may undertake under current statutory authority and therefore could be implemented immediately. The members of all four trade associations believe that implementation of these proposals will make market conduct examination procedures more efficient without jeopardizing any protections afforded by market conduct examinations to the consumer.

The specific 12 points advocated by the four property and casualty trade associations are as follows:

1. The overriding goal of market conduct examination should remain as stated in the Market Conduct Examiners Handbook, which states, "the market conduct examination can be most effective if it focuses on general business patterns of practices of an examinee. While not ignoring random errors, the market conduct examination should concentrate on an insurer's general practices." Examinations that focus on single inadvertent errors do little to further consumer protection and do not maximize the use of market conduct resources of the Insurance Departments.

2. States should strive for greater coordination among the states as concerns scheduling and conducting market conduct examinations of insurers. States should be encouraged and should more fully utilize the Examination Tracking System at the NAIC. Members of all four trade association oppose applying the multistate examination concept to property and casualty insurers. There are simply too many variations in the market conduct standards from state to state in the property and casualty area to make the multistate examination process feasible at this time.

3. Departments should rely more fully on targeted market conduct examinations rather than comprehensive examinations. Departments would be better served directing resources to "problem" companies in the market conduct examination area. Complaint volume, sudden changes in complaint volume and utilization of desk audit tools could be used by Departments in identifying "problem" companies.

4. The NAIC should develop and the Departments should follow uniform standards on examination notices, including sufficient advance notice and notice regarding change in scope of the examination.

5. Departments need to exercise greater oversight and control of examination costs. Tools that should be utilized in this area include (a) sharing and discussing with the insurer prior to the market conduct examination the Department's time budget and work plan for the examination; (b) sharing budget projections with the insurer and developing compensation standards when the Department utilizes contract examiners; and (c) developing a peer review system or other appeals process for review of examination billings when there is a dispute between the insurance company and the Department over a billing.

6. All states must adopt and adhere to the procedures and guidelines set forth in the Market Conduct Examiners Handbook.

7. The NAIC should develop and the Departments should follow uniform standards for requesting data from insurance companies during market conduct examinations and for the collection of this data.

8. Final examination report changes are needed. First, the NAIC should develop and states should follow a uniform standard for when such final examination reports must be completed. Second, insurance companies should be given the opportunity to include within the final examination report a discussion of any disagreements that the company has with the findings and the company's reasons for those disagreements. This will allow subsequent examiners within the same department or examiners in other states that will review the final examination report to be aware of and have an opportunity to consider the insurer's disagreements and reasons for the disagreements.

9. There must be a rational basis for assessing administrative penalties and establishing the size of those penalties. The penalty structure should also allow the insurance company to take remedial action to correct any violations uncovered in a market conduct examination. If such action is taken within a reasonable time, administrative penalties should be waived or reduced. This penalty structure is consistent with the overall objective of market conduct examinations, which is to identify and eliminate insurance company practices in violation of the insurance code and regulations.

10. The NAIC and states should continue to adopt minimum training standards for market conduct examiners. This may include requiring designations under the Accredited Insurance Examiner or Certified Insurance Examiner programs for specified market conduct examiners. Minimum training standards involving technology or the use of automated market conduct techniques should also be developed and required of examiners. Training programs on the Market Conduct Examiners Handbook and the proper purpose of market conduct examinations should be developed and encouraged. Both the regulatory and insurance communities must fully support the efforts of the Insurance Regulatory Examiners Society.

11. Insurance companies must be given sufficient time in which to come into compliance with new or amended statutes and regulations that require changes in company operation, Too often the statutes or regulations require compliance within an unreasonably short timeframe, particularly when they require system changes for insurance companies. The

NAIC should encourage and state insurance departments should work with the industry in promoting this objective in all legislation and regulation impacting company operations.

12. The NAIC should adopt the National Conference of Insurance Legislator's Insurance Compliance Self-Evaluative Privilege Model Act as an NAIC model.

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TESTIMONY OF ILLINOIS STATE REP. TERRY PARKE

NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

HEARING ON

INCREASING THE EFFECTIVENESS OF STATE CONSUMER PROTECTIONS

WASHINGTON, D.C.

MAY 6, 2003

Rep. Kelly, Members of the Subcommittee, my name is Terry Parke. Let me first express my thanks for the opportunity to speak to you today.

It is my privilege to represent the residents of Schaumburg and Hanover Townships in the Northwest suburbs of Chicago in the Illinois General Assembly.

It is also my privilege to have served as President of the National Conference of Insurance Legislators (NCOIL) in 2001.

In that capacity, I testified on the modernization of insurance regulation before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, chaired by Rep. Baker, on June 21, 2001.

In that testimony, I said that effective market conduct regulation would be essential to overall modernization. That testimony pointed out that strong regulation of conduct in the marketplace would be essential if states moved from present day prior approval systems to strong regulation targeting actual company misconduct.

In today's testimony, I will provide you with the content of a preliminary report of the Insurance Legislators Foundation (ILF), an educational and research arm of NCOIL. NCOIL is happy to release the document in conjunction with the holding of this hearing. The preliminary report was received by the ILF on May 2 and will be the subject of a public hearing at the Hotel InterContinental in Chicago on June 6.

NCOIL will welcome comments from consumers, insurance industry representatives, and insurance commissioners at that hearing. We would especially welcome comments from members of this Subcommittee on that day or at any other time. The preliminary report will receive full consideration at NCOIL's Summer Meeting in Williamsburg, Virginia, on July 10 through 13. The probable outcome will be referral to the NCOIL State-Federal Relations Committee for appropriate action.

The preliminary report identifies fundamental and sweeping changes that would bring insurance market regulation into the 21st Century. It offers ideas that can bring insurance regulation into line with the reforms and new attitudes that have begun to emerge in the regulation of financial services in the U.S. and overseas.

The preliminary report contains ideas that would benefit consumers by eliminating costly regulatory redundancies, redundancies that increase the costs of products and stifle innovation. Such regulatory redundancies can also deter an insurer from entering markets and thereby reduce consumer choice.

Those recommendations, if adopted by NCOIL, could lead to model legislation that would serve as a companion piece to NCOIL's commercial property and casualty insurance modernization model act, which would allow property-casualty insurers to change rates without first receiving approval from state insurance regulators. Nineteen states have already enacted the essential provisions of that NCOIL model act. NCOIL recently adopted a similar model act for personal and commercial lines, which would allow freedom from rate approval.

Rep. Kelly, Members of the Subcommittee, changes in market conduct regulation remains an essential and indispensable component of improving the efficiency and effectiveness of insurance regulation and insurance markets in America.

INTRODUCTION AND BACKGROUND

I will first provide some necessary background then proceed to report to you on the key features of the preliminary report.

By way of background, it is not insignificant to note that my own state of Illinois introduced market conduct examinations in 1971, in tandem with its move to competitive rating. That rating system has enabled Illinois consumers to benefit from premium levels below those of most other populous states. In Illinois, market conduct examinations evaluate underwriting, advertising, agency operations, marketing and claims practices. Those examinations measure the actual performance of insurers and their personnel against the insurance policy contracts that the insurers have with their customers. The system joins a degree of market freedom with holding insurers accountable for keeping their promises. But even in my own state, there may be a need for a public policy review aimed at streamlining market conduct regulation in the way identified in the preliminary report, which NCOIL has released in conjunction with this hearing.

Today's report is part of the second and final phase of a four-year study of market conduct regulation. James Schacht of PricewaterhouseCoopers and Dr. Robert Klein of Georgia State University conducted both phases of the study and prepared the preliminary report.

The first phase of that study, completed in 2000, found, among other things,

- wide disagreement regarding the purpose of market conduct examinations, especially as to whether such examinations should focus on general business practices or only on specific violations of law; and

- little coordination of market conduct examinations by states, leading to widespread and wasteful redundancies.

Today's preliminary report responds to those and many other real world, present day issues.

Underlying our efforts is the fact that things have changed dramatically since a 1973 study by McKinsey & Company recommended that insurance regulators should separate market conduct surveillance from financial surveillance. Costly litigation, court judgments and large fines have prompted many insurers to try to avoid costly outcomes and the resulting damage to reputation and franchise value. Prudence, common sense and market realities have provided insurers ample incentive to conduct themselves properly in the market. Today every well-run insurer has a chief compliance officer and written policies and procedures to facilitate and enforce compliance with state insurance laws and regulations.

That is not to say that mistakes, errors, and non-compliance do not occur. They do occur and they will occur. But it is to say that an effective compliance program will minimize such problems. And, most important, it is also to say that it will remediate them when found.

KEY ELEMENTS

The preliminary report released this afternoon identifies ways to achieve an effective compliance program. It recommends a comprehensive self-policing program. Elements of that program include:

- standards for insurers' compliance programs, including CEO certification of compliance;
- incentives for insurers' self-assessment activities;
- a comprehensive system for filing and accessing consumer complaint information;
- domiciliary state responsibility for market conduct surveillance with coordination of targeted multistate examinations; and
- development of model legislation.

It is not my intention today to focus on criticism of the present system of market conduct regulation. I will, however, reference that criticism when necessary to report on the specific reforms identified in the preliminary report.

COMPLIANCE STANDARDS

Critics say that the present market conduct surveillance system fails to acknowledge insurers' compliance programs, self-assessment, and independent assessment activities.

The preliminary report shows how states could establish standards for effective compliance programs. Most specifically, the preliminary report envisions a regulatory approach in which the CEO of each regulated insurer would certify that the company he or she manages has complied with those standards. Regulators would provide guidelines that companies would use in building and maintaining effective compliance programs. Let me note that the emphasis would be not just on the compliance program itself. The emphasis would be on a company's monitoring of its compliance program and its effectiveness. And most important, the emphasis would be on the company attesting to that effectiveness.

Naturally, such a compliance program will require several key components, including

- written policies and procedures to ensure compliance;
- oversight of high level personnel;

- monitoring of compliance function;
- availability of anonymous reporting, as well as protection of whistle-blowers;
- employee awareness of the need to comply and cooperate fully in investigations of alleged misconduct;
- clear communication with senior management and directors, as well as regulators;
- reviews to adjust to market changes and new products, as well as new laws; and
- company membership in standard-setting organizations.

INCENTIVES
Such a system would include incentives for insurers' self-assessment activities aimed at detecting improper market conduct practices. Our earlier report noted that 85 percent of the insurers surveyed performed critical analysis or retained independent assessors to detect improper market conduct practices. Self-assessment activities improve compliance, discourage violations, and foster correction. NCOIL adopted a model law establishing the validity of such self-assessment activities in 1998. I was the sponsor of the bill when Illinois adopted it in 1998.

This concept of self-policing is not unique to insurance regulation.

I call your attention to the Securities and Exchange Commission's (SEC) issuance of a Section 21(a) Report, Release No. 44969. It provided a detailed rationale of why the Commission was not taking any enforcement action against a specific company for the actions of a former company controller who had knowingly engaged in wrongful behavior.

The Commission cited the company's proactive and cooperative efforts in explaining the matter. The SEC used the company's action as a basis for providing a framework that the Commission would use to decide whether and how to address violators of federal securities laws. The framework included self-policing, self-reporting, redemption, and cooperation.

What the SEC did was send an unmistakable message that it would provide meaningful incentives for companies to quickly and openly respond to identified violations. Please note that the SEC made it clear that it was not providing a way for companies to avoid liability and sanctions. Rather, the SEC said that a company's proactive and cooperative actions could mitigate the degree of sanctions following a finding of liability. The SEC's intent is to encourage companies to analyze and deal -- quickly and positively -- with adverse compliance events. Conversely, a company could purposefully ignore the initial discovery of facts if the company believed that the only outcome would be for it to face significant liability.

Other regulators are shifting from prescribing specific behaviors or controls to articulating principles or guidelines for companies to follow, and then allowing them to develop effective controls for meeting them.

For example, there has been a sea change in the regulatory approach adopted by the Financial Services Authority since it became the United Kingdom's sole financial services regulatory authority. The new approach allows firms to shift from simply avoiding regulatory scrutiny and penalties to embedding compliance within their organizations.

Closer to home, another clear example is the recent anti-money laundering requirements for the insurance industry. The adopted rule for insurance companies, concerning Section 352 of the Patriot Act, provides as follows:

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

Beyond some very broad directives and components, the rule is silent as to any specific program elements. The minimum requirements simply say that the anti-money laundering program "...incorporate policies, procedures and internal controls based upon the insurance company's assessment of the money laundering and terrorist financing risk associated with its products, customers, distribution channels and geographic locations."

Commentary related to the proposed rule emphasizes that each company will need to design controls specifically tailored to manage the identified compliance risks associated with its unique business environment.

The same change has begun to take place in the states. I note with enthusiasm that the Massachusetts Division of Insurance has begun to take steps to improve the knowledge and performance of insurance company boards of directors in the state.

I also call the attention of the Subcommittee to efforts of the Insurance Marketplace Standards Association (IMSA). IMSA has developed guidelines and uses independent assessors to examine and evaluate a company's control environment.

COMPLAINT FILING

Our preliminary report makes the point that enhancement or replacement of the National Association of Insurance Commissioners Complaint Database would serve as a tool for identification of companies worthy of targeted examinations. Clearly, a national complaint database would be an important component of the new system that the preliminary report envisions. Such a database could aggregate complaint data and measure it in ways useful to regulators and consumers.

The existing NAIC database may require further improvements to serve the function required. Just as clearly, all states need to participate to achieve a new system. A truly useful database will need to accommodate regulators, consumers, agents, brokers, and insurers. Regulators need a database that alerts them to complaint patterns. Consumers need complaint information to help make purchasing decisions. Agents and brokers need it for business purposes. Insurers can use it to improve compliance.

DOMICILIARY STATE RESPONSIBILITY
The preliminary report notes that there is often a lack of coordination with regard to multi-state examinations.

It identifies the idea of giving the domiciliary state the main responsibility for monitoring the surveillance activities of an insurer and its affiliates.

MODEL LEGISLATION
Critics point to a lack of statutory authority with regard to market conduct surveillance. Only two states, Illinois and Florida, have laws that specifically address market conduct surveillance. In each case, the law only addresses market conduct examination and does so in a very limited way. This obvious failing demands correction.

The preliminary report notes that the development of model legislation is outside the scope of the study, but presents numerous elements that could be included in such legislation. Consideration of the report could lead to the development of an NCOIL model act subsequent to adoption of the report. It is only through consideration and adoption of such a model -- as a clear statement of public policy -- that we will achieve efficient, effective, and uniform market conduct regulation, the kind that would be, as I noted above, a key element in state regulatory modernization.

Such a model could, if necessary, establish in statute many of the policy and procedural standards I have already identified. Among other things, such a model law could

- establish clear authority of the state to carry out market conduct examinations;
- require that the State Department of Insurance promulgate standards for insurer compliance;
- require company certification of compliance;
- allow acceptance of examination reports of companies domiciled in other states;
- allow for the applicability of the NAIC Model Examinations Law in regard to immunity for whistle-blowers and in connection with self analysis documents;
- set the timing and frequency of examinations; and
- authorize the commissioner to conduct only targeted examinations triggered by, for instance,

- high complaint frequency;

- inadequate and incomplete compliance programs;

- failure to assess compliance to an adequate degree; and

- emergence of marketplace issues, e.g. race-based rates, transition to competitive rating, single point of filing and/or one-stop licensing.

At the same time, compliance reviews would be embedded in regulatory functions. For example, the regulator, prior to licensing an insurer to do business in a state, would review a company's compliance programs and internal controls. Regulators could conduct similar reviews simultaneous to changes in management, ownership, entry into new lines of business, or changes in compliance patterns.

CONCLUSION

The preliminary report recommends that the purpose of market conduct regulation, and particularly examinations, should be to prevent and remedy unfair trade practices that have a substantial adverse impact on consumers, policyholders and claimants. Resources should not be wasted on detecting and correcting minor processing errors or inadvertent minor violations of laws and regulations. Insurers should be accountable for their own monitoring and compliance with uniform state standards. Regulators should pursue abuses and take actions that will result in the mitigation of the greatest harm and restoration of the greatest benefit to consumers and the public.

The preliminary report provides much more discussion on the reform elements and issues I have identified. I offer it for your consideration and input and I would be more than happy to respond to your questions.

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NAIC

making progress . . . together

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June 2, 2003

Honorable Luis Gutierrez, Ranking Member
Subcommittee on Oversight and Investigations
Financial Services Committee
U.S. House of Representatives
Washington, DC 20515

Dear Representative Gutierrez:

Thank you for the opportunity to testify on behalf of Oregon and the National Association of Insurance Commissioners (NAIC) at the Subcommittee's hearing on May 6th entitled "Increasing the Effectiveness of State Consumer Protections". I was pleased to inform the Subcommittee on the NAIC's ongoing efforts to create a more effective and efficient system of state market regulation. As I stated during my testimony, effective and efficient market regulation that is focused on local consumer needs is the hallmark of state insurance regulation.

As requested, I am responding to your questions posed to me following the hearing. Over the years, the NAIC and its members have cooperated fully with important inquiries by Congress into the adequacy of the state regulatory system and we again appreciate the opportunity to provide information about state market regulation reforms. We believe these inquiries have demonstrated that state regulation of insurance is the best way to meet the demands of consumers for this unique financial product.

Question 1

In Mr. Hunter's testimony, he pointed out that the NAIC should be collecting or requiring states to collect data sufficient for markets analysis. These data, he said should include information such as zip codes to see if redlining is occurring, information on third party vendors that impact underwriting and pricing with products such as insurance scores and CLUE claim reports. Could you discuss some of the problems that consumers are experiencing with insurance scores and CLUE reports?

Response to Question 1

Market analysis is a top priority of the NAIC, and we are pursuing two initiatives that will provide guidance to states on what data should be collected and analyzed as part of the market analysis function.

The first market analysis initiative is the development of a Market Analysis Handbook, which will provide a comprehensive list of data and information that is already available to regulators and compile ways this data can be used. This data and information, if used correctly and uniformly, can assist states in identifying possible predictors of potential problems, assist states in using their resources better, and assist states in developing a more detailed understanding of the marketplace. During 2003, the NAIC will focus on how states may use the following three sources of data to target the most significant market problems: 1) complaint data, 2) relevant financial data and 3) market share information.

The second market analysis initiative is the market conduct annual statement. The annual statement is a market analysis tool that all states can use to review market activity of the entire insurance marketplace in a consistent manner and to identify companies whose practices are outside normal ranges. Greater specifics on the annual statement are provided in response to question 2.

As to your specific question about credit-based insurance scores, states have been actively monitoring the use of credit information through their rate approval process. Most states have moved beyond information gathering and have taken action, either administratively or legislatively, to address consumer abuses in the use of credit information. Similar to the use of other rating and underwriting factors, states may prohibit the use of credit scores if the use results in unfair discrimination. Beyond this general guideline, some states prohibit the use of a credit score as the sole rating or underwriting factor. Other states have focused on disclosure and now require insurers to notify consumers if credit information will be used in the underwriting and rating process. Finally, some states require credit scoring models to be filed with the state insurance department.

The NAIC has supported these efforts by developing a consumer brochure to help consumers understand how insurance companies use credit information and how the use of credit scores affects how much individuals pay for insurance (Attachment 1). The brochure answers the following types of questions and is attached for your reference.

- Can an insurance company look at consumers' credit information without their permission?
- What kind of credit information do insurance companies use?
- Must an agent or company tell a consumer what his/her insurance credit score is?
- How can consumers improve their credit score if they have been adversely affected?

The NAIC has also developed an analysis of regulatory options (Attachment 2). This document provides the pros and cons of a broad range of regulatory options states may choose to reference when establishing state public policy, laws and regulations addressing the use of credit scores. More specifically, the document addresses the following major issues: underwriting issues, rating issues, insurance scoring model issues, and disclosure issues. This document is attached for your reference.

Finally, in response to your question about CLUE reports, the chief market conduct examiners of the state insurance departments have been actively tracking and discussing this issue at NAIC national meetings. Theoretically, the same information obtained through a CLUE report would be disclosed by an applicant on application; however, questions about how CLUE reports are affecting the availability of insurance and the proper regulatory response are still being explored. At the upcoming NAIC Summer National Meeting the chief market conduct examiners will receive a report and engage in a detailed discussion with a representative from ChoicePoint.

Question 2

With regards to the pilot program that you describe in your testimony, what sorts of information has been included within the markets conduct annual statement. Since property and casualty insurers began collecting data in January, what issues have shown to be of concern for state regulators and consumers?

Response to Question 2

The pilot annual statements ask a series of questions on sales, claims practices and other factors that we think will help identify companies with market problems (Attachment 3). The emphasis differs between the life and property and casualty statements, with the former focusing more on sales issues and the latter focusing more on claims issues. This difference in emphasis is based on historical experience as to where the most significant consumer problems are in each industry.

The life annual statement is designed to answer the following types of questions.

- What companies have indications of potential churning or unusual replacement activity in individual life and annuity business?
- What companies have the highest ratio of consumer complaints?
- What companies take the longest time to pay death claims?
- What companies have the highest rate of contested claims?

The property and casualty annual statement is designed to answer the following types of questions.

- What companies take the longest to pay claims?
- What companies have the highest rate of lawsuits by first-party and third-party claimants?
- What companies may be changing their personal lines auto underwriting for some reason, e.g., not properly reviewing risks before accepting them or unfairly canceling or non-renewing?

- What companies may be changing their homeowners underwriting for some reason, e.g., not properly reviewing risks before accepting them or unfairly canceling or non-renewing?

It still is too early to say what we've discovered about the property and casualty industry since the first data filings aren't due until Sept. 1, 2003. Copies of both the life annual statement and the property and casualty annual statement are attached.

I and the members of the NAIC look forward to working with Congress and within state government to improve the national effectiveness and efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

Sincerely,

Joel Ario
Insurance Administrator, Oregon
Secretary-Treasurer, National Association of Insurance Commissioners

Enclosures

RESPONSES TO CONGRESSMAN GUTIERREZ'S QUESTIONS
BY J. ROBERT HUNTER
CONSUMER FEDERATION OF AMERICA

QUESTION #1

The NCOIL approach amounts to an industry wish list. Consumers cannot trust the proposal NCOIL makes.

The basic proposal is self-regulation: self-audit privilege, reliance on process not outcomes, credit for best practices organization membership. The concept is too reliant on self-certification (Post-Enron this is an extremely risky idea).

Insurers are not becoming more trustworthy as the Report implies...indeed, there is a lot of evidence that the opposite is true and quick profits are sought more than integrity. The findings of the Report are primarily based on this faulty finding. Insurance companies are run more and more by money managers not insurance professionals.

The report is focused on cost to the insurers (efficiency) and not the cost to consumers of continued market abuses (effectiveness).

The Report gives no thought to the role of private causes of action, a critical component since market conduct reviews are powerless to obtain restitution.

The Report does not discuss what went wrong in market conduct exams up to now that caused such harm to consumers since they caught little of the abuse until reporters or lawsuits made the abuses known.

The report claims that inadvertent errors should not be detected. But if you are the consumer hurt by the error, how are you healed?

Dangerous to have the state of domicile in charge since it is most subject to political pressure (If one place is central it should be NAIC empowered to do it) The Report makes complaints a key trigger for MC review. This is fine but we see lots of abuse in, say, claims handling where the consumer would never know the abuse was occurring.

Limiting MC exams to only companies with real or perceived problems will allow the more duplicitous to get away with abuse for a longer time.

NCOIL's concept is all about reducing cost and creating uniformity, nothing on effectiveness -- either whether or why effective or ineffective in the past or how to measure effectiveness in the future. There is no empirical basis to conclude that any of the report's recommendations will improve consumer protections -- all the proposals are based upon belief that they will help, but there is no evidence to indicate that self-audit privilege or membership in best practices organizations have any effect on market conduct performance.

The authors talk about uniformity, but no mention of minimum resources or accreditation standards

They talk about reliance on state of domicile, but no mention of minimum capacity or capability of state. There is no logic for selecting the state of domicile and there is no basis to assume that any state has the minimum resources and integrity to perform minimum mc functions. Worse, the state of domicile is most subject to political pressure.

The study presents no analysis of why regulators have missed market conduct problems in the past – CFA believes that regulators have failed to identify such problems in the past because they did not want to find them. Commissioners have simply refused to collect and look at information to examine issues. Why did it take NFHA to discover that age and value of home underwriting guidelines were unfairly discriminatory? Even today, when we tell regulators they have to collect review and analyze underwriting guidelines, they balk. Why did it take fair housing groups, lenders and federal agencies to discover the abuses of single premium credit insurance? Regulators did nothing and are still approving bad products. Why have no regulators done anything on redlining? Why do so many refuse to collect zip code data? Why do all regulators refuse to endorse public availability of zip code data? Credit scoring -- the disparate impact on consumers by income and race is obvious -- the evidence is there if you want to see it -- yet regulators don't do anything.

Bob's point on complaint data is right on -- complaint data is useful, but by no means sufficient to identify market conduct problems. Regulators have had complaint data in the past, yet failed to identify the problems.

Another problem with study -- no recognition of limitations of regulators in identifying and addressing market conduct problems -- need to not only bring insurers into the process with best practices organizations and corporate culture but also bring consumers into the process with public availability of information to allow consumers to analyze market performance -- just as with HMDA for lending. Of course, the right to a private cause of action is essential here.

Hypocritical for regulators to argue against class actions when they can't protect consumers

Recapping our thoughts on the NCOIL report:

It is simply an industry wish list - self-regulation
No empirical evidence to support proposals
No minimum resource standards
No standards for gauging effectiveness
No recognition of regulators' limitations and need for bringing public into mc regulation

The report's authors obviously have not read the McCarran-Ferguson Act or choose to ignore it. The authors suggest that insurers should regulate themselves or that other private entities like Insurance Marketplace Standards Association (IMSA) should regulate (if one once to charitably assume that IMSA is NOT really just a group of insurers.) The congressional drafters of McCarran-Ferguson and the Supreme Court have warned the states that they cannot transfer the borrowed authority that they hold. In the case of Federal Trade Commission (FTC) v. Travelers Health Association, 362 U.S. 293 (1960), Justice Potter Stewart wrote the majority opinion which warned the states: "In this case, ... we are asked to hold that the McCarran-Ferguson Act operates to oust the Commission of jurisdiction by reason of a single State's attempted regulation of its domiciliary's [362 U.S. 298] extraterritorial activities. {3} But we cannot believe that this kind of law of a single State takes from the residents of every other State the protection of the Federal Trade Commission Act. In our opinion, the state regulation [362 U.S. 299] which Congress provided should operate to displace this federal law means regulation by the State in which the deception is practiced and has its impact." To illustrate his point further Justice Stewart quoted Senator Joseph O'Mahoney (D-WY) who brokered the McCarran-Ferguson Act to explain the limits on states inability to transfer the authority given to them by Congress: "Nothing in the proposed law would authorize a State to try to regulate for other States, or authorize any private group or association to regulate in the field of interstate commerce." These admonishments by the Court question the viability of using private interstate compact commissions, the IMSA, lead state arrangements or reciprocity agreements that are not approved by Congress to regulate insurance. These arrangements simply invite application of FTC oversight.

The report's authors recommend what the Courts have called a "pretense of regulation," and the courts have ruled that a pretense of regulation does not fulfill the states' duties under McCarran-Ferguson. The reports authors only needed to read the Supreme Court decision in Federal Trade Commission v. National Casualty Co., 357 U.S. 560, 563, 2 L. Ed.2d 1540 to understand the folly of their recommendations. This was a direct mail case where the FTC tried to exert authority over insurance solicitations. The Court ruled that where states had acted affirmatively through passage of unfair trade practices acts the FTC had no jurisdiction. But the court cautioned the states that it is not enough to just pass laws and never use the authority granted under them. (I believe the new NAIC commercial lines rating model fails on this test because it "reserves the authority to regulate" rather than applies the authority to regulate.)

This idea of a pretense of regulation is a very important one in Supreme Court history. It arises again in a later dissent from a denial of cert, [OHIO AFL-CIO, UNITED AUTOWORKERS OF OHIO v. INSURANCE RATING BD., 409 U.S. 917 (1972)] Justice Douglas stressed the "pretense of regulation" prohibition: "In Federal Trade Commission v. National Casualty Co., 357 U.S. 560, 563, 2 L. Ed.2d 1540, after examining the statute and its legislative history, we held that federal regulation as to advertising practices was prohibited in those States which were regulating such practices under their own laws. We indicated, however, that the grant of exclusive regulatory power to the State would be ineffective if the state statutory provisions which purported to regulate were a 'mere pretense' of regulation."

The report's authors were correct to look at the McKenzie Report but they missed the point. The McKenzie report calls for the separation and strengthening of market conduct regulation because the financial side was not doing it. The NCOIL report separates it and starves it.

QUESTION #2

The organization with which I was affiliated in the late 1980's, the National Insurance Consumer Organization, published a book, "Taking the Bite Out of Insurance – How to Save Money on Life Insurance," in which we documented most of these abuses and warned consumers about them, years before the first market conduct exam in these areas was initiated.

QUESTION #3

Not all forms of competition are beneficial to consumers. Selection competition is a way that insurers can maximize profits by trying to avoid certain risks. Thus, older and sicker people may be denied health and life insurance or up-rated under selection competition, thus causing uninsured populations to grow. Redlining of our cities is another form of selection competition.

Reverse competition is another form of competition that adversely impacts consumers. Under this form of competition, prices rise rather that decline as competition intensifies. This is because the person who will get a commission or other kickback as part of the deal makes the real selection of the insurer. Credit insurance, forced-ordered property insurance and other forms of insurance suffer from reverse competition. For instance, a car dealer may offer credit insurance as part of the loan package. The dealer gets a commission. The dealer also selects the insurer (people don't go out looking for credit insurance, typically). Because the dealer profits, the dealer picks an insurer with big commissions. Prudential Insurance Company once testified that they did not sell much credit insurance because they were "not competitive...our rates are too low!" This sort of competition means higher prices to the consumer and requires regulation.

Regulation is also, contrary to the hype of those seeking to avoid it, NOT the opposite or at odds with competition. Both seek to secure a good or service for the lowest possible price consistent with a fair return to the provider. Consumers have been best served in insurance regulation by the California system put into effect by that state's voters in 1988. Proposition 103, which maximizes both competition and regulation to the benefit of consumers, has been the best system for consumers in the nation. For instance, since its introduction, California's auto insurance rates have fallen from third highest in the nation (under the then free competition system) to below the national average premium, a remarkable success for consumers.

QUESTION #4

Use of credit scoring by insurance companies presents a serious problem to consumers. First of all, there is no logical explanation for why a person's credit score relates to their driving record or homeownership capacity. A classification system should be logically related to risk.

If a class is logically related, such as driving record in auto insurance, then that logical factor is tested by statistical correlation. Insurers maintain there is a strong correlation when it comes to use of credit history, but we are not allowed to test it because the data they use is not made available.

So consumers believe that this classifier has not been justified.

Further, we are convinced that the use of credit history is a surrogate for race and income and would not be allowed to be used if these were directly applied.

Also, a recent CFA study, "Credit Score Accuracy and Implications for Consumers" (12/17/02), showed that errors of commission and omission were rife in the credit histories, raising very serious accuracy issues in the use of these scores.

Credit scoring should be banned for use in insurance underwriting and pricing.

CLUE reports make more sense than credit scores. CLUE is a database of claims. Use of claims history in underwriting and pricing makes sense.

The problem with CLUE is that people have been surprised by the database. For example, as a home nears closing, the CLUE report is now obtained and may signal that a home has a claim problem that makes the home uninsurable. This may delay the closing. Thus, realtors have been concerned about CLUE.

Consumers must be educated about CLUE. The data in CLUE must be cleaned up and verified by consumers. This effort must be increased and the use of CLUE made more palatable by reducing error rates and education of consumers, realtors and other interested parties.

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STATEMENT

OF THE

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (NAMIC)

TO THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

HEARING ON

"INCREASING THE EFFECTIVENESS OF STATE CONSUMER PROTECTIONS,"

WASHINGTON, D.C.,

MAY 6, 2003

The National Association of Mutual Insurance Companies (NAMIC) and its more than 1,300 property and casualty member companies appreciate the opportunity to offer these brief comments to the Subcommittee on Oversight and Investigations on the occasion of its public hearing on "Increasing the Effectiveness of State Consumer Protections."

For the past three years, NAMIC has been actively engaged in conversations with state insurance regulators over the need for them to develop "a new market surveillance program, operating under the premise that most insurance companies are in business to treat their policyholders fairly, and only companies that violate that trust should be pursued and punished."

This finding, part of a NAMIC public policy paper published in April 2002, made the case that current state market surveillance efforts are too focused on conducting market conduct examinations of insurance companies with little or no coordination among the states. As a result, insurance companies are often subjected to expensive, duplicative examinations that are conducted over several months and then several more months go by before findings are published – often after the company already has addressed the issue that prompted the exam.

To help put some perspective on this issue, the following represent figures from two member companies. The first example shows the exam expenses for a large, multi-line company licensed in every state.

Between 1994 and 1999, this company saw its exam expenses increase from an average of $200,000 a year to $1.2 million in 1999.

The second company can best described as a regional multi-line company doing business in 19 states. Between 2000 and 2003, this company was examined 11 times. The average cost of reimbursing the regulators performing each of these on-site exams was $50,000. The company also incurred expenses associated with dedicating four of its employees to coordinate exam responses and spending 50 to 80 data hours per exam, at a cost of $325 an hour, to retrieve data from their computer systems to satisfy requests from the regulators.

A company spokesperson notes that the forfeitures for the 11 exams ranged from zero to $15,000. He considered that most violations were "technical" in nature, that is, they were for such things as not responding to a Departmental request within 10 business days. None of the violations directly affected any of the company's policyholders.

In making its public policy statement in 2002, NAMIC was not implying that state insurance regulators should become less vigilant in overseeing the marketplace or in protecting consumers, but rather that they should develop a less expensive, more efficient process that focuses only on the most egregious behaviors.

NAMIC believes this new market surveillance process should begin by having regulators develop an "analytical approach" to market regulation where existing data collected from the insurance companies is used to "test" all insurance companies in the marketplace. This would apply to all companies: large, medium and small, with the idea that no one company would fall through the cracks. From this analysis, regulators should then focus on only those insurance companies that fall outside of some predetermined acceptable standard of behavior.

Any follow up, NAMIC believes, should begin with an informal discussion with the insurance company that identifies the problem and allows the company the opportunity to respond. If the response is not acceptable to the regulator, then, and only then, should the regulator consider conducting a market conduct examination.

This "analytical" approach, with its emphasis on "targeted" market conduct exams as opposed to "routine" exams, strikes us as the most sensible way for states to more effectively oversee the regulation of the insurance marketplace.

To its credit, the National Association of Insurance Commissioners (NAIC), through the work of its Market Regulation & Consumer Affairs (D) Committee, has begun to embrace several of the concepts that NAMIC endorses here and is currently working on some "pilot" projects in that regard.

However, as with any discussion that involves change, some state insurance regulators have shown an unwillingness to consider any new, more efficient approaches to market regulation and, instead, continue to labor under the impression that conducting full-blown market conduct examinations is the best approach to market regulation.

NAMIC appreciates the interest that this Subcommittee and the full House Committee on Financial Services has shown in the past few years on the need for state insurance regulation to become more uniform and efficient. We believe hearings like this one today will help to frame the parameters for these deliberations, and we appreciate this opportunity to offer our observations on how market regulation should be conduced in the future.

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