February 5, 2014

To NAIC Advisory Organization Examination Protocol Working Group:

Thank you for the opportunity to comment on the Advisory Organization Examination Standards from the perspective of a recently-examined advisory organization. This letter summarizes and expands upon my comments from the December 2013 meeting in Washington, DC. For your convenience, I have bolded the key recommendations.

As you know, the advisory organizations were involved in drafting the Standards as they exist today. From my perspective of having managed all of ISO’s regulatory examinations since the 1980’s, the Standards were comprehensive and fairly self-evident to regulators and others familiar with the roles and work of advisory organizations. While they do provide the appropriate framework, in hindsight it appears that the Standards would benefit from revisions that make some of the underlying knowledge and assumptions more explicit so that the exam can be more efficiently administered by examiners who are not thoroughly familiar with the differences between insurers and advisory organizations, and the consequent need to approach an advisory organization exam somewhat differently.

To that end, my first recommendation is that the Advisory Organization Chapter should be understood to be self-contained, as it was designed to be. One of the key issues we encountered during the ISO exam was the arbitrary and inappropriate imposition of insurer standards to our operations. These ran particularly to "efficiency standards" that relate primarily to solvency issues that have no bearing on advisory organizations in that we are not subject to solvency regulation, but also toward what I would characterize as governance issues. I think that the governance issues can and should be added to the Advisory Organization chapter in a way that is compatible with our role. Further, if there are ad hoc review standards for a particular exam, they should be discussed by the lead states and the examined entity before they are administered by the contract examiners.

From ISO's perspective, the two most important elements of any exam are its efficiency and overall cost. A key concern of ISO's executives regarding the recently-completed exam is the
cost difference between the recent multistate exam and our previous exam, conducted by New York Insurance Department staff with the assistance of a contracted examination firm for selected key items, specifically the IT and actuarial portions. Our New York exam was equally comprehensive in scope, yet cost one-third of the multistate exam. Since our systems and procedures are multistate in nature, it is difficult to comprehend how the costs were so different. It should be only marginally more expensive to review a multistate operation over that which is applied to a single state.

One reason I think that the ISO exam was so much more expensive than it might have been was that there was not the necessary recognition that all the data-related protocols need to be administered in sequence, in order that the checks and balances that are inherent in each of our systems and procedures be evaluated in context for their sufficiency in providing the necessary protections to assure high-quality data for statistical agent and ratemaking purposes. Our systems tend to be longstanding, relatively simple, straightforward, and have built-in redundancies, which as a whole have stood the test of time. What I think we encountered was an evaluation from the perspective of how the examiners thought our systems should work, rather than how they actually do work, what I have sometimes described as fitting square pegs into round holes. To that end, I suggest several changes to the Chapter:

- The Chapter should be structured to emphasize that data-related protocols need to be administered in sequence. This would have reduced the need for ISO to produce the same documents multiple times over the course of the exam; rather they would be introduced at the point in time when they are meaningful.
- The examiners should be specifically charged with reviewing the systems and procedures as a whole as they exist, and identifying gaps that could result in compliance issues with regulatory requirements for data used in loss cost and other pricing filings, and statistical agent reports. Emphasis should be added to the chapter that this is a compliance review, and resist temptation to veer off into business advice.
- If the exam is to be conducted in whole or in part by a contracted examiner, a bidders conference should be held before the bids are submitted so that the bidders can obtain specific detail from the advisory organization about its processes and procedures. I envision that the advisory organization would give a high-level overview of its processes and procedures under examination and answer questions so that all bidders are in possession of a realistic understanding of the work involved. This should reduce the "risk load" inherent in bidding on the unknown. This process was used successfully during the 1990's when Texas undertook an examination of all statistical agents for personal auto data.
- Before the examiner develops the detailed work plan for the exam, the advisory organization should present in detail how it believes it complies with the standards. It should emphasize the multistate processes as well as any necessary adaptations to comply with specific state requirements. This would reinforce the necessary understanding that the examination is focused on evaluating the sufficiency and potential weaknesses of how the advisory organization performs its regulated functions, rather than on how the examiner might envision such a system.
- From the ratemaking perspective, the data systems should be evaluated for what they are: tools used by experienced data managers and actuaries to produce results
that are reflective of the relevant insurance experience, not as ends in themselves. The checks and balances that are part of the ratemaking process are human, experience based, not IT-driven.

The Actuarial section of the examination would probably also benefit from the inclusion of additional material. Care needs to be taken that "back end" regulation (i.e., an examination) does not re-regulate what has already been regulated in the "front-end" by way of the filing approval process. What benefit would there be if an examination actuary came to a different conclusion from a state's actuary in approving a filing? (This scenario isn't hypothetical, it actually came up during an exam in the 1990's and resulted in the entire exam never being finalized.) For example, ISO's filings contain detailed information on the actuarial procedures used, and we answer many detailed questions from state actuaries during their filing review. From that perspective, in a routine compliance examination, **there should be no need for review of the advisory organization's pricing formulae, as they have already been subject to extensive front-end regulation.** Even in file-and-use states, the use of the same processes and formulae as the prior approval states should preclude any need for a detailed actuarial formulae review.

Finally, I think a few process issues surrounding Advisory Organization Exams need to be solidified:

- We need a more certain **process in getting appropriate acceptance of the examinations by the states** that signed-on to the exam.
- Now that the comprehensive first time through exams are completed, **we should consider what following exams should look like.** At a very high level, I would expect there to be reviews of whatever is new at the advisory organization, with at most a small random sample of re-review of already reviewed operations.
- Finally, we might want to **consider examination frequency**, especially for those entities whose "clean" exams exhibit a strong and longstanding focus on their compliance operations.

Overall, we were pleased with our first examination under the Advisory Organization Protocols. Nothing substitutes for excellent and open communication between the lead regulators and the examined entity. ISO was very fortunate in having excellent and knowledgeable lead regulators who oversaw the more routine parts of the exam, as well as expertly navigating the issues above as they came up. My deepest thanks to Anne-Marie Narcini, Rolf Kaumann, Kendra Coates and Elaine Newman for all the time and effort they put into the ISO examination.

Very truly yours,

Mary Van Sise
Vice President