Risk Focused Market Conduct Examinations

It is suggested that the following be placed after item B (What is Market Analysis?) in Chapter 1 of the *Market Regulation Handbook*. This section is intended to introduce the risk-focused approach to the market conduct exam. Also, this section familiarizes examiners with the risk-focused surveillance process, which is the next logical step in developing the Market Analysis techniques suitable for a risk-focused oversight process.

Risk-Focused Market Conduct Regulation

Risk-focused market conduct regulation means directing regulatory efforts toward the review and analysis of the most critical issues, those identified as having the greatest potential for consumer harm or disruption in the marketplace. Under a risk-focused approach, regulators identify and prioritize issues based upon their assessed potential impact (risk) to the achievement of desired regulatory outcomes.

The intent of this risk-focused process is to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of an insurer. The risk-focused approach is designed to provide continuous regulatory oversight and extend the examination process to not only encompass the risks present as of a specific examination date, but to consider risks which extend or commence during the time which the examination was conducted, and risks which are anticipated to arise or extend past the point of completion of the examination.

Risk-focused market conduct examinations can be used to identify and assess risk, assess the adequacy and effectiveness of the strategies/controls used to mitigate risk and assist in determining the extent and nature of procedures and testing to be utilized in order to complete the review of a particular activity. The process should generally include a determination of the quality and reliability of the corporate governance structure and risk management programs. In addition, it can be used for the verification of specific operations of an insurer, such as claims processing. The risk assessment process should result in increased focus on, and can result in increased substantive testing of, areas being at high risk of non-compliance. Conversely, the risk assessment process should result in decreased focus on and fewer substantive tests (if any) on the business areas identified as being at low risk of non-compliance. The risk-focused surveillance process can be used to assist examiners in targeting areas of high-risk.

The Risk-Focused Surveillance Process

The intent of the risk-focused surveillance process is to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of the insurer. This assessment could be completed on a legal entity basis or on an organization-wide basis depending on how the company structures its business. Over the years, state insurance regulators have developed numerous tools to address insurers' risks. The risk-focused surveillance process, which will be based on the Market Analysis platform, utilizes an

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organization-wide risk assessment process to enhance evaluation and to better coordinate the activities of market conduct examinations through greater consistency within the department, and with other departments.

A risk-focused surveillance process includes identifying significant risks, assessing and analyzing those risks, documenting the results of the analysis, and developing recommendations for how the analysis can be applied to the ongoing monitoring of the insurer. This increased attention by regulators to risk assessment and risk management processes utilized by insurers will be a positive development. The enhancements included in the risk-focused surveillance process intend to provide the following benefits:

1. Strengthen regulatory understanding of the insurer's corporate governance function by documenting the composition of the insurer's board of directors and the executive management team as well as the quality of guidance and oversight provided by the board and management.

2. Enhance evaluation of risks through assessment of inherent risks and risk management processes regarding weaknesses of management's ability to identify, assess and manage risk.

3. Improve early identification of emerging risks at individual insurers on a sector-wide basis.

4. Enhance effective use of regulatory resources through increased focus on higher risk areas.

5. Increase regulatory understanding of the insurer's quality of management, the characteristics of the insurer's business and the risks it assumes.

6. Enhance the value of surveillance work and establishment of risk assessment benchmarks performed by insurers and regulators, who have common interest in ensuring that risks are properly identified and that adequate, effective control systems are established to monitor and control risks.

8. Expand risk assessment to provide a more comprehensive and prospective look at an insurer's risks through identification of the insurer's current and/or prospective high-risk areas.

9. In full, the risk-focused surveillance process provides effective procedures to monitor and assess the market activities of insurers on a continuing basis. This approach consists of a structured methodology designed to establish a forward-looking view of an insurer's risk profile and allows for a direct and specific focus on the areas of greatest risk to an insurer. Through this approach, state insurance regulators can be more proactive and better positioned to identify and respond to any serious threat from any current or emerging risks. This regulatory approach will benefit all participants in the insurance marketplace.

Application of the Risk-Focused Surveillance Process

The risk-focused examination approach should be an asset to examiners in understanding a company and planning the examination to focus on key risks. Once examinations are fully

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implemented in accordance with this approach, examiners and analysts should continue to maintain this approach as an ongoing process in order to stay informed of organization or external changes that will impact the company and their identified risks. If implemented in this manner, examiners should be able to maintain efficiencies when conducting examinations as they utilize knowledge gained in previous exams, and from the analyst's ongoing monitoring, to be aware of key changes and risks at the onset of examinations.

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