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## **Thoughts on Market Regulation -A Corporate Governance Approach to Market Conduct Examination**

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### ***Introduction***

Even though market conduct concern was one of the founding issues when the NAIC was formed in 1871, the first known Market Conduct Examinations didn't happen until approximately 1969. These examinations were performed by the Illinois Insurance Department starting in 1969 and were followed by their neighboring state Missouri in 1972. Alaska performed some rate examinations in the mid 1970's as did Washington, Oregon and California. In 1974, the NAIC funded McKinsey report suggested that a new examination format (other than Financial) be developed and used. In 1979, the General Accounting Office (GAO) was particularly critical of regulatory failure to systematically analyze complaint data and to use that data in an examination process. The criticism went further concerning the exchange of that information and efficient use of state resources in its market regulation efforts.

It has been said that you have to learn to crawl before you can learn to walk and learn to walk before you can learn to run. These early efforts were the crawling stage and admittedly mistakes were made. At the time, the information age was not really underway and the necessary information sharing, communication needs and data gathering capabilities were viewed as futuristic. State laws governing market issues were viewed as too diverse to allow for multi-state or collaborative efforts. As a result, the form taken was somewhat vague and provided for an individual state quantitative review. Nevertheless, states began to commence efforts aimed at enhancing the new examination process.

Beginning in 1994, some states realized that it was time to learn to walk. The Market Conduct Examiners Handbook at that time contained little in the way of guidance to a state wishing to conduct a Market Conduct Examination. States recognized that even

though the various state statutes supporting their reviews were diverse, there was sufficient similarity to allow for general standards or expectations to be developed. It was these standards that would be used to move in the direction of uniformity. This was a considerable departure for many in the field. Although states developed relatively uniform market conduct standards, Market Conduct Examinations did not receive the same attention given to Financial Examinations which were broadly accepted earlier. The absence of a similar level of oversight in the Market Conduct Examination area of regulation allowed inefficiencies and other issues to develop unchecked. Nevertheless, with the adoption of standards, the Market Conduct Examination process had learned to walk.

The material that follows could be viewed as a substantial departure from what is viewed as a conventional Market Conduct Examination. The author believes it is the next logical step in the evolution. Accordingly, the suggested techniques that follow are concepts for national regulation. Several states have acted as laboratories developing these concepts. Additional states are extremely interested in the concepts but need more detail. It is important for the NAIC to take these concepts and provide the detail similar to the suggestion in this concept paper. The approaches discussed require the increased use of an examiner's analytical skills. The testing suggested here does not necessarily result in a pass or fail, yes or no, or black or white response. Nevertheless, it represents a potential for the acquisition of better information pertinent to a regulated entity's operations than does a conventional Market Conduct Examination. This author believes the approach be considered as an augmentation of the currently available examination tool.

Briefly stated, this approach is the review of the directions provided by a regulated entity's management in the form of written procedures (hereafter, processes), directives, processes, strategies, etc. This review reveals how a regulated entity manages and controls the various processes it implements to comply with insurance statutes.

This approach is an effective means to determine whether regulated entity management in an area or areas under review is proactive or reactive. A proactive process generally results in a minimal level of error or violation. A reactive process has an increased propensity for error and violation. If the process is flawed, compliance is compromised.

### ***Political Change and Resource Allocation***

In recent years, Market Conduct Examinations and their continuing role in the regulation of insurance have evoked considerable discussion expressing criticisms and concerns. The criticisms and concerns have arisen from a variety of sources including regulated entities, the GAO and from regulators. The list below is not in any particular order of importance or impact and is not all-inclusive:

- The disproportionate burden on large market share insurers
- Concern with duplicative efforts
- Concern with efficiency of the process

- The absence of collaborative efforts among states
- The methodologies utilized to select examinees
- Concern with the resources available to states
- Ability of Departments to manage process in view of budgetary cuts
- Federal interest in insurance market regulation
- Events identified in an examination tend to be historical and do not necessarily reflect on current conditions
- The need for better tools to identify violation causation.

Every state performs Financial Examinations, but the same is not true of Market Conduct Examinations. The former is the subject of an accreditation process that essentially provides a mandatory structure for financial oversight of the insurance industry. The discussion for a similar structure for market regulation has not seen such a structure arise in part because not all states are equally active in market regulation. Many states would have substantial difficulty developing such a structure due to competing demands on state budgets.

Most states that conduct Market Conduct Examinations do so on a target basis. Routine and comprehensive examinations are rare. Many states feel that resource allocation is better served through the target examination mechanism. The key for market regulators is how to refine an appropriate regulatory structure that includes all elements needed to avoid past inefficiencies, yet provide effective oversight that comports with the intent of statutory mandates to regulate insurance.

### ***GAO Criticism***

On September 30, 2003, the Government Accounting Office (GAO) issued its report “GAO-03-433 Insurance Regulation.” This report was critical of states’ efforts in the area of Market Analysis (information gathering to determine issues and identify companies that may need attention) and on-site examinations in market regulation. The report also criticized the progress made by the NAIC in creating more uniformity in the regulation of market conduct. A downloadable copy of that report is available at <http://www.gao.gov/new.items/d03433.pdf>.

### ***Examination Structure - Developing New Tools***

The conventional method of examination as described in the *NAIC Market Regulation Handbook* typically reviews the results of a regulated entity operation for error or violation of statute and reacts to that result. It is generally quantitative and microscopic in nature. This approach is reasonably effective at identifying violations of state law. It uses sampling methodology to select files for review and then applies standards and tests to

determine whether the files reviewed comply with the applied test. This results in considerable duplication when multiple states have similar concerns and conduct separate examinations. The conventional method of examination is truly cumbersome when applied on a multi-state basis unless the subject of the examination is sufficiently narrow and the state laws for the examining states are sufficiently similar. It is, however, not particularly effective at determining causation of file failure. The principal regulatory interest in developing new tools for review is not the quantification of violation or error, but rather the qualification of the management structure and its ability to provide effective compliance. It is also particularly useful in structuring corrective action.

The conventional Market Conduct Examination utilizes a review of events at the operational level of an insurer. These results have already occurred so the review is historical. A Corporate Governance approach reviews all levels with emphasis on the management and control of processes of interest to market regulation.

In an effort to avoid the criticism of duplication in regulation, states revisited the role of Market Analysis. Market Analysis had existed in states actively engaging in Market Conduct Examinations in some form or another for years; however, it did not possess the refinements that have been developed recently. In its current configuration, Market Analysis is being used to determine which of a variety of regulatory responses are appropriate to a particular set of circumstances. As this process becomes more refined, and as the states collaborate in their regulatory efforts, much of the duplication can be expected to dissipate. The challenge is to recognize more effectively and efficiently the indicators that should lead to some form of regulatory interaction.

When a state conducts a review, finds violations or errors and tells a regulated entity to fix it, a difficult condition may be established. The regulated entity may have no more of an idea of what has caused a violation or error than does the regulator. For that determination a qualitative review is needed not a quantitative one. The only way to arrive at a qualitative utility is to adopt reviews that look more intensively at the process and controls affecting corporate governance. Like the reviews to which financial examiners are moving, the overall techniques are similar but rely on very different experience bases. The Financial Examiner reviews corporate governance, from the viewpoint of the reviewer's background in accounting, investment and/or financial management experience. The Market Conduct Examiner reviews corporate governance from the viewpoint of the reviewer's background in underwriting, claims, and/or contract review experience.

The review process discussed in this paper is a review of management structures and controls of areas impacting market related issues. This approach is very effective at identifying *causes* for violations of statute. The Corporate Governance Market Conduct Examination utilizes a review of the processes and controls developed for the operations of an insurer.

In its' 2003 report, the GAO recognized the need to include Corporate Governance elements in the examination approach with the following statement in its' conclusions: "In addition, existing computerized audit tools could allow regulators to substantially

change the way examinations are done by shifting the focus from file review to a review of controls, systems, and processes and possibly by shortening the time needed for the examination.”

### ***Enabling Statute***

The statute enabling a Corporate Governance review is already found in state examination statutes and in the admissions statute. The language in the examination statutes is generally similar from state to state and provides broad authority to examine matters of regulatory interest to the states.

The provision of interest in the admissions statute is that related to competent management. An enabling statute reads something similar to the following:

“The Commissioner shall not grant or continue authority to transact insurance in this State as to any insurer or proposed insurer the management of which is found by the Commissioner after investigation or upon reliable information to be incompetent or dishonest or untrustworthy or of unfavorable business repute or so lacking in insurance company managerial experience in operations of the kind proposed in this State as to make such operation, currently or prospectively, hazardous to or contrary to the best interests of, the insurance-buying or investing public of this State, or which the Commissioner has good reason to believe is affiliated directly or indirectly through ownership, control, reinsurance transactions or other business relations with any person or persons of unfavorable business repute or whose business operations are or have been marked, to the injury of insurers, stockholders, policyholders, creditors, or the public, by illegality, or by manipulation of assets or of accounts or of reinsurance or by bad faith.”

In some cases the reference is somewhat less direct. For example:

“It is the duty of the commissioner to examine all requests and applications for licenses to be issued under the authority of this title, and the commissioner is authorized to refuse to issue any such licenses until the commissioner is satisfied of the qualifications and general fitness of the applicant in accordance with the requirements of the insurance laws.”

In fewer cases the reference appears only in the Commissioners authority to revoke or suspend the regulated entity’s license. For example:

“The certificate of authority of an insurance company to do business in this state may be revoked or suspended by the commissioner for any reason specified in this title. Specifically, the certificate may be suspended or revoked by the commissioner for reasons that include, but are not limited to use of methods that, although not otherwise specifically

proscribed by law, nevertheless render its operation hazardous, or its condition unsound, to the public or to its policyholders.”

### ***Review Considerations***

An examination that utilizes the Corporate Governance approach should be based on an understanding of the considerations that contribute to the efficacy of the process. If the considerations and the logic that support the approach are not thoroughly understood, it is not likely that the method can be used effectively. This usually means that the examiner will be focusing on the written processes in use by the regulated entity.

### **Management Cycle**

The management of a well-run company adopts processes that are similar in structure to ensure compliance. An absence or ineffective application of such processes in a regulated entity often results in an inconsistent application of the intended process. Ineffective processes are typically revealed by adverse findings in samples tested during the course of a Market Conduct Examination. The processes include the following components:

- A planning function where direction, policy, objectives, and goals are formulated
- An execution or implementation of the planning function elements
- A measurement and control function that considers the results of the planning and execution, such as an internal audit function that looks to test and refine the effectiveness of the control or process
- A reaction function that utilizes the results of measurement to take corrective action or to modify the process to develop more efficient and effective management of the regulated entity’s operations.

### **Planning**

The planning function is where direction, policy, objectives, and goals are formulated. This function is found most often in the written policies and written process of the regulated entity. These may also be called processes, strategies, or directives, and are tested for clarity, currency, functionality, and conflict with existing statutes. A proactive process that results in reduced error or violation is one that is clearly stated, up-to-date, fits its intended purpose, and complies with state laws. A reactive process generally results in observable errors and violations that the regulated entity can not avoid, because it is not structured to do so. Absences of policies suggest areas that need to be tested. Findings from this review are predictive of areas where an examiner’s review of a sample will yield criticisms and errors. They also provide the examiner with data that helps identify whether problems found

are systemic, intended, unintended, or true error. Finally, review findings aid the planners of the examination in determining what business areas may need further examiner attention.

### **Implementation**

Implementation of the planning function occurs when management-directed policies and written processes are disseminated throughout the regulated entity to appropriate and affected persons. Review of this process is useful in determining whether the regulated entity is effectively distributing its directives. Testing the implementation of the planning function involves answering many questions including:

- Are the processes in writing?
- Are the written processes coherent, readable, and on point?
- Are the written processes functional; that is, do they fit their intended purposes?
- Do the written processes comport with statutes and contain state exceptions where applicable?
- Are the written processes up-to-date?
- Are the written processes readily available to affected persons?
- Are the written processes utilized?
- Are affected persons trained in the use of the written processes?
- If the written processes are computerized, is the documentation for the resultant process adequate and does the process accomplish management's intent?
- Is the process periodically tested and updated?

### **Measurement**

The measurement function evaluates the results of planning and implementation. Measurements can be found in internal audits, management reports, supervisory reports, Board meeting minutes, minutes of the Compliance Committee, minutes of the Quality Review Committee, Market Conduct Examination reports, etc. The measurement function is concerned with the quality of information developed to inform the management and the Board of the results and the effectiveness of its directives. It must develop information that confirms or refutes that the intended process is utilized, functioning and working. Without measurement, management cannot know whether its directions are being implemented effectively. The measurement process must be written, formal, and documented, and must occur with sufficient frequency to function as a reasonable tool. Without the measurement function in place, the process used is passive or reactive, and the regulated entity will

not have an effective means for knowing that errors or violations are occurring and be in a position to prevent them. This is where the regulated entity exercises the control over the intended process and is critical to the effectiveness of that process.

In an actual example of a proactive process, examiners discovered a single error when reviewing the underwriting files of an insurer. When examiners discussed the error with the insurer, they found the regulated entity already had detected the potential for that kind of error. The regulated entity went on to establish an internal task force to devise a means of preventing such errors in the future. Examiners also found that the regulated entity, on a semi-annual basis, reviewed 25 files for each of its underwriters and claims persons. Furthermore, the tests in the regulated entity review were more stringent than those applied in the examination process. The regulated entity used test results to evaluate its employees and to target areas for additional training. Moreover, the results were applied in a manner that was both accepted and welcomed by regulated entity employees. The regulated entity designed a highly effective method for providing concrete evaluation of its directives.

### **Reaction**

The reaction function is where a regulated entity has the opportunity to insert into the process what it learned through the measurement of its written processes. The process requires a means of utilizing the information arising from internal audits, management reports, and complaint systems. This is reflected in the responses to internal audits, management reports, supervisory reports, Board of Directors and Committee minutes, Market Conduct Examinations, and errors detected through the regulated entity's complaint system analysis.

This information needs to flow back directly to management so that it can use these findings to modify policies and written processes. The regulated entity should also resolve, through documented remediation, any errors that resulted in harm to policyholders and/or the public.

These are things that a regulated entity should know about itself. In some cases federal law insists on it. The Sarbanes-Oxley Act (SOX) essentially requires documentation that certain levels of corporate governance are in place and operating.

### **The Cycle**

The cycle of preparing instructions (policies and written processes), disseminating them, testing their results, and making modifications should be a continuous and ongoing cycle. A continuous and ongoing cycle is indicative of proactive management. Of course, not every regulated entity is fully proactive or fully reactive. A regulated entity can be at both ends of the proactive/reactive spectrum depending on the business area being reviewed. For example, a regulated entity with a proactive claims environment may have a reactive underwriting environment.

## ***Policies and Procedures***

Policies and procedures are two terms heard with some frequency, but they do not tend to evoke an image of how they might be used in a regulatory application. These terms in fact denote two different things.

### **Definitions**

“Policies” are the high-level general principles by which an entity guides the management of its affairs. It is not critical for the regulator to be concerned with policy statements except to the extent that they represent management's direction to proceed in a particular manner. Policies may be the basis for procedures. Policies are generally too vague to require any regulatory interaction unless they are obviously in conflict with a statute.

“Procedures” are the specific methods or courses of action used to implement a policy or corporate directive. Many companies have processes in place that do not derive from policy and do not really constitute procedures. In this paper, a written procedure is referred to as a written process. How a regulated entity structures and documents its written processes tells the regulator a considerable amount about the regulated entity. Written processes indicate whether a regulated entity is proactive or reactive in the management of its operations; whether the corporate compliance activities are a cause for concern; and whether particular areas of concern to the regulator are managed in a way to avoid the need for regulatory interaction.

### **Source**

Throughout the *NAIC Market Regulation Handbook*, there are suggestions in the review criteria for the various standards to review a particular procedure. Unfortunately, the Handbook is silent concerning what constitutes such a review. The review of a procedure should determine whether the management cycle relating to the process at interest adequately considers each of the elements noted in the discussion of the management cycle.

Management analysis of written processes is a top-down look at how a regulated entity operates. It can be thought of as a vertical view of a regulated entity's operation. It represents a somewhat different skill set than typically used in the traditional Market Conduct Examination that is more of a “bottom of the ladder” view or horizontal view of a regulated entity operation. Both methods are valid and may be used in conjunction with each other. To test the validity of the use of this approach, examinations have been conducted for the last four years utilizing both methods, procedural and traditional including sampling. The examiners have then compared the results of the samples impacted by particular written processes with the management analysis performed relating to that process and the findings have been striking.

## **Testing the Process**

Since the examinations conducted during this testing phase have been comprehensive examinations with reasonable levels of sampling, the samples support the notion that the proactive/reactive analysis is a valid tool. The samplings of business areas for companies with proactive tendencies generally yield fairly “clean” results. Where the analysis indicated that there was a passive or reactive process in place or no process in place, the samples revealed considerable human error, systemic error, and certainly more deliberate errors than are seen with proactive management.

Approximately 30 conventional Market Conduct Examinations were completed with a Corporate Governance review element during the testing phase of Procedure Review. No attempt was made to develop comparative statistics during the testing phase as the utility of the process discussed in the section on “Review Uses” was not then anticipated. The written processes reviewed were also a variable from examination to examination, thus exacerbating statistical development.

## **Processes to Review**

The written processes to review vary depending on the lines of business (LOB) written by a regulated entity, the reason for examination (target or “baseline”, which is defined later in this document), and a variety of other considerations. The following is a list of written processes that can be modified as needed:

- Audit [ Internal and External ] (All LOB)
- Assertions of privilege (All LOB)
- Regulated entity records, central recovery, and backup (All LOB)
- Computer security (All LOB)
- Anti-fraud (All LOB)
- Disaster recovery (All LOB)
- MGA oversight and control (All LOB)
- Vendor oversight and control (All LOB)
- Customer and consumer privacy protection (All LOB)
- Complaint handling (All LOB)
- Grievance handling (Health)
- Grievance expedited review (Health)
- Advertising, sales, and marketing (All LOB)
- Producer communications
- Suitability (Life, Annuity, Health)

- Producer training (All LOB)
- Replacement [Life, Health, (LTC) ]
- Illustration (Life)
- Outline of coverage (Health)
- Network adequacy (Health)
- Producer selection and appointment (All LOB)
- Producer termination (All LOB)
- Producer defalcation (P&C, Health)
- Prevention of use of persons with felony conviction (All LOB)
- Assumption reinsurance (All LOB)
- Premium billing (All LOB)
- Return Premium (All LOB)
- Statistical gathering and reporting (P&C)
- Correspondence routing (All LOB)
- Policy issuance (All LOB)
- Reinstatement (Life, Health)
- Insured or member requested claim history (P&C, Health)
- Credible coverage (Health)
- Premium determination and quotation (All LOB)
- Policyholder disclosures (All LOB)
- Underwriting and selection (All LOB)
- Rate and form filing (All LOB)
- Termination (All LOB)
- Rescission (All LOB)
- Declination (All LOB)
- Pre-existing conditions (Health)
- Underwriting file documentation (All LOB)
- Administration of self funded entities (Health)
- Insured or member enrollment (Life, Health)
- Continuation of benefits (Health)
- Staff training (All LOB)

- Claim handling (All LOB)
- Internal claim audit (All LOB)
- Claim file documentation (All LOB)
- Denied and Closed Without Payment (ALL)
- Subrogation and deductible reimbursement (P&C)
- Reserve establishment (P&C)
- Provider Credentialing and Recredentialing (Health)
- Quality Assessment (Health)
- Quality Improvement (Health)
- Utilization Review (Health)
- Utilization Review Adverse Determination (Health)
- External Review (Health)

### ***Additional Considerations***

In addition to the considerations noted above, ethical management, management attitude, and confirmation of management processes are appropriate.

#### **Ethical Management**

A critical element in any scheme to develop allocation of examiner resources is ethical management. Ethical management is not a direct standard in the *NAIC Market Regulation Handbook*. It is usually not a direct requirement of the statutes regulating the business of insurance. However, the need for ethical management is strongly implied through the structure of those statutes. For example, a pattern of misrepresentations will raise strong doubts about an insurer's ethical base. The standards and tests found in the Handbook are generally objective indicators that can measure this behavior. Factors such as regulated entity attitude and negative, confrontational, or resistive reaction by regulated entity management may be more subjective, but no less apparent, to the regulator. Likewise, a regulated entity with a reputation for being a "good corporate citizen" typically demonstrates a willingness and structure that is responsive to its customers.

#### **Attitude**

Examiners experience a wide range of attitudes on the part of insurer management. Most examiners are instructed to adopt an attitude of being cordial, but firm. Listen to explanations; evaluate on the basis of your knowledge and powers of observation; and act accordingly. The fact that a regulated entity may not want to be examined is no

excuse for negative, belligerent, or discourteous treatment of examiners. A negative attitude on management's part is a strong hint that the regulated entity is not likely to receive a "clean" bill of health on its Market Conduct Examination.

### ***Application of the Corporate Governance Approach***

The application of a Corporate Governance methodology consists of several steps with variations dependant upon the particular process under review. The steps are:

- Determine which processes to review
- Provide an information request to the regulated entity.
- Consider the quality and completeness of responses
- Test the structure of the process
- Test the content of the particular process
- Confirm the process is as represented
- Document the review
- Determine whether issues that arise merit reporting in a report or in a management letter

### **Determination of Processes to Review**

The most likely use of this approach will be to apply a combination of the examination standards already outlined in the *NAIC Market Regulation Handbook (Handbook)* or state specific handbook and a Corporate Governance review of selected processes. This will be generally driven by the reasons for conducting the examination. The examination supervisor will need to evaluate, given the information derived from market analysis, which standards in the *Handbook* require a conventional approach or quantification and which require a Corporate Governance approach. In some cases, both methods will be attractive. The decision to apply Corporate Governance methodology may be deferred until sample results suggest a need.

### **The Information Request**

Reasonable structure to the information request is critical to a timely and thorough understanding of a particular process. There are a series of requests that should be made for any process reviewed. Some of these are generic to all processes while others are specific to the particular process.

1. The examiner will want to know what led the regulated entity down a particular path in its development of a process. For this reason, the first item requested should be a copy of the risk assessment and control process that formed the

- starting point for the process. This document should identify and enumerate the operational and regulatory risks to which the regulated entity is exposed and what it needs to do to control or mitigate that risk. In many cases this document will not exist and that will make the examiners effort a bit more difficult. This may be partially overcome with interviews of mid and upper management.
2. The examiner should request a complete description of the process including applicable written procedure used to operate and control the process. The regulated entity should also describe how errors are detected and corrected in the process. The regulated entity should note if the process is contained within a computerized application. If the process is computerized, the documentation for the process and how it works should be described.
  3. Request a description to indicate how the process is conveyed to persons affected by it and how those persons are trained in its use. The response should include how the process is accessed; describe training related to the process and how the Regulated entity confirms that the process is being utilized.
  4. Request a description of the methods used to monitor compliance with the process to ensure it is performing as intended. The response should include a description of the frequency of measurement. Also request copies of any management reports or forms used for this process.
  5. Request a five-year history and description of changes to the process.
  6. Request the name, position and title of the person in the regulated entity responsible for the effective operation of the process under review.

Additional requests should be designed for the specific process under review. For some processes the added questions will be extensive while in others none will be necessary. A good source for additional information request related to a specific process is the testing criteria for a related standard in the *Handbook*.

### **Quality of Information Request Responses**

The examiner, where possible, should receive a number of process responses prior to arriving on-site. This provides an opportunity to determine if the regulated entity has provided complete responses of sufficient quality to be useful. The Examiner-in-Charge might want to arrange a test of a process selected jointly with the regulated entity to assure that the level of understanding of expectations is reasonable. Since the information contained in the responses is generally sensitive, additional caution to maintain confidentiality is necessary.

### **Testing the Structure of the Process**

The first level of testing a process is focused on the quality of the process. These are tests that apply to all processes reviewed using Corporate Governance methodology.

They are generic tests. The items that follow are expressed as questions that should be posed to gain an understanding of review of the process. The examiner should provide responses to these questions in the documentation of his or her review.

1. Has a risk assessment been conducted? Does the risk assessment address compliance issues?
2. Do the mitigations noted adequately address the risk noted? Are any obvious mitigation elements missing?
3. Is a written procedure or process in place? The absence of a written policy or procedure potentially allows an inconsistent application of the process. If not in writing, how does the Regulated entity assure consistent application of the process?
4. Is the procedure or process unambiguous, clear and readable? Does the examiner understand the process or procedure described? Would employees understand the process or procedure? Examiner should explain analysis.
5. Is the procedure or process accessible and provided to persons subject to its provisions? How the procedure or process is made accessible to those persons? How are they made aware of the existence of the procedure?
6. Does the Regulated entity provide adequate training to persons affected by the procedure or process? What training is provided? How does the Regulated entity ensure those affected by the process receive training? How are employees re-trained if a problem is found?
7. Are appropriate measurements or controls in place to test the functioning and efficacy of the procedure or process? How often is the procedure or process reviewed, tested or audited? How does management exercise oversight and control of the process? How is the procedure or process reviewed, tested or audited?
8. How does management utilize the results of its measurement structures? Explain and provide examples, how the results of measurement structures are utilized.
9. Is the procedure or process performing as intended? How do you know the procedure or process performing as intended? If it is not, where is it deficient? Is it possible to know if the procedure or process is performing as intended?
10. Is the procedure or process current? When was process last modified? Have events suggested a need for update such as legislation or product line change? Please explain revisions and their reasoning if provided. Were revisions proactive? Reactive? Are any changes the result of an examination?

### **Testing the Content of the Particular Process**

The second level of testing a process is focused on the content of the specific process. These are tests that apply only to the specific process reviewed using Corporate Governance methodology. A good source for tests applicable to a specific process is the testing criteria for a related standard in the *Handbook*. The examiner should provide responses to these questions in the documentation of his or her review.

### **Confirmation**

Often a regulated entity claims to maintain a process or procedure, but in fact it does not. Therefore, in using this methodology it is important that the examiner confirm the existence **and use of** the processes a regulated entity purports to maintain. This can be accomplished in several different ways:

- The first is conducting a “walk-through”. This exercise provides the examiner with the opportunity to question how the process actually functions. The examiner should have questions prepared so he or she can achieve a thorough understanding of what the regulated entity does.
- The next method is the use of interviews of upper and mid-level managers and of persons using the purported written process. Some companies may use an informal or undocumented process. The efficacy of such processes should also be considered. The challenge with an undocumented process is that it is frequently without measurement, meaning that the regulated entity really does not know how that process is working. It also means that there is an increased likelihood of inconsistent application, posing potential unfair discrimination issues.
- The final method is to actually test a sample of files to determine that the process is indeed applied as described.

### **Documenting the Review**

The Corporate Governance methodology is more subjective than application of a standard that has a pass or fail option. It is therefore especially important that examiner work be carefully documented. Worksheets are recommended to assure that some consistency of application is maintained.

### **Report or Management Letter?**

A flawed process may not be a violation of statute or regulation. It may not be causing violation but may represent a potential for violation. The risk for such an event may be low and not warrant inclusion in an examination report. Some states utilize a management letter for low risk situations when it is desirable to provide the regulated entity with an opportunity to correct or repair a system flaw. This device is less threatening to the regulated entity and provides an opportunity for more cordial communication.

## ***Review Uses***

The use of Corporate Governance methodology has a wide range of utility. It can be used as a stand-alone form of examination or it can help to narrow a focused review of an area of the regulated entity's operations. It is also recommended as an augmentation of a conventional examination.

### **Domestic Baseline**

The phrase "baseline examination", as used here, contemplates an initial examination of a regulated entity conducted by a state. It is expected to provide a "baseline" of information on which to base future regulatory oversight or absence thereof.

The advantage in this instance is that the state of domicile possesses the authority to look at business areas that other states cannot. This is true whether the domestic regulated entity is a large writer in the domestic state or writes no business at all in the state. The written processes a regulated entity utilizes are generally corporate-wide. The domicile state thus has the opportunity to look at how the regulated entity treats compliance on a scale that is broader than its own immediate interests and to provide other states with information of strong interest to them. This is a meaningful way to address a state's interest in achieving domestic deference.

Typical baseline examinations are conducted on a state's domestic insurers. The examinations look at a regulated entity's total complaint population to determine if there are any detectable patterns that may suggest a need for regulatory interaction. The reviews should not be limited to a single line of business or to a single jurisdiction, but they should consider all jurisdictions in which the regulated entity operates. Examiners conducting the baseline examination consider complaints directed at the regulated entity, its producers, its vendors, etc. The object is to look for developing patterns anywhere and to determine if the regulated entity maintains processes to correct or repair the issues driving the patterns.

In addition, examiners review about 40 written processes for each regulated entity examined, unless the examination is for a group of companies using the same written processes and controls. The process takes approximately nine weeks utilizing three examiners for a single regulated entity and a bit more when there are multiple companies subject to the examination. Generally, half of the work can be conducted off-site, resulting in travel-related expense savings. This review also replaces the market conduct work performed as part of a financial examination. The expectation is that this will provide considerable information about each of the state's domestic companies, thereby allowing better future allocation of a state's regulatory resources. For example, this type of examination can identify companies with reactive or passive management styles and, consequently, allow a state to focus greater attention upon those companies. Data developed in this process should be incorporated into a state's Market Analysis efforts, thus providing a true baseline for future efforts.

It is not unusual to find a regulated entity with few, or no, written processes. Even more commonplace is finding a regulated entity that has no way to tell whether its written processes are working since measurements are non-existent. If the regulated entity writes a line of business that does not generate consumer complaints, there may be few other valid indicators of regulatory concern. Maintenance of the data in the baseline, once acquired, is easy to accomplish with minimal effort.

The baseline examination departs substantially from the definition of a conventional Market Conduct Examination. However, in view of recent NAIC discussions, experience in proactive/reactive analysis, and the need for states to accomplish their examinations with minimal resources, states might well consider a baseline examination. Examinations that focus on the regulated entity operations and management, proactive vs. reactive analysis of each business area, and a detailed review of patterns that arise from complaint systems provide an insurance commissioner with the necessary data to determine when and where a more limited-scope, targeted examination is appropriate in addition to enhancing data derived from Market Analysis.

### **Target Examinations**

The analysis completed in the Corporate Governance Examination is exceptionally predictive; it lends itself to a more precise application of Department resources. Other indicators used in Market Analysis may suggest that a specific review of a particular process is warranted. This next level of review may be accomplished using the Corporate Governance methodology as a stand alone process or combined with a conventional Market Conduct Examination.

### **Identification of Causation**

When a trade practice or repeat violation of statute is found through Market Analysis, a conventional examination or complaint review, using a focused application of Corporate Governance methodology, is useful in identifying causation. Once the cause of the violation is determined, the regulator is able to develop recommendations to repair the issue or structural remediation with precision.

### **Market Analysis Supplement**

Market Analysis is seeking ways to gather and review data that indicate the need for regulatory interaction. Corporate Governance methodology is a valuable tool that provides a means of achieving this goal. However, because the process is relatively new, it will be some time before there is an adequate database upon which states can rely.

## ***Conclusion***

The use of Corporate Governance methodology has several advantages. These include:

- It can be used on a targeted or routine basis.
- It requires less time to conduct, and a considerable amount of the work can be conducted off-site.
- The review conducted tends to be corporate wide rather than state specific, thus increasing the multi-state utility of the process.
- It is readily able to identify causation and potential areas of regulatory slippage.
- It tends to be less confrontational since development of violations is not the primary function.
- It is highly predictive of where violations have occurred or are likely to occur thus allowing for proactive activity.
- It provides an opportunity for objective regulator/regulated entity dialogue.
- It provides value for the examination costs to the regulated entity.
- It can be used as a stand-alone examination or as a supplement to a conventional examination.
- It is responsive to domestic deference concerns.
- It offers the regulated entity the opportunity to improve compliance in a real way.

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### ***Author Information***

Don Koch, CIE, MCM is the Director of Market Regulation and a Principal of NorthStarExams, LLC. His insurance career started in Philadelphia in 1960. He worked for the Alaska Division of Insurance for 27 1/2 years where he served as Chief of Market Surveillance. In this capacity he supervised the rate and form filing section; trained examiners; structured the examination process; and supervised or conducted Alaska's Market Conduct Examination efforts. Don held concurrent positions at various times as Acting Director of Insurance, Acting Deputy Director of Insurance, and Special Deputy. He chaired the NAIC Working Group that drafted the current Market Conduct Examination Handbook and participated in numerous other working groups and Committees. Following his tenure in Alaska, he was the Contract Supervising Market Conduct Examiner in Delaware for 9 years.

NorthStarExams, LLC provides regulatory services to state governments primarily in the area of Market Conduct Examinations and Training.

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