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.

m:\ncoil\2003923.doc