

The Financial Impact of Effective Market Conduct Examination Management

In the insurance industry, market conduct examinations are a fact of life. They're also a major source of concern for many compliance professionals—and for some very good reasons:

- Lengthy examinations consume a lot of resources.
- Negative examination outcomes, often delivered with a high price tag, can substantially affect a firm's bottom line.
- Negative examination outcomes can also harm the overall brand health of the company—harm that can linger for months or years.

When compliance professionals have an in-depth understanding of the true costs of market conduct examinations, they become more keenly aware of the importance of exam management and elevate it to one of their top priorities.

The Bottom Line is the Bottom Line.

Opportunities for ongoing cost control exist throughout the exam process and fall into three key areas of focus:

1. Understanding the true costs of market conduct examinations
2. Effectively preparing for future examinations
3. Controlling costs during in-process examinations

This paper explores these areas of focus, as well as actions that insurers can take to identify cost-saving opportunities, improve exam results, and reduce further compliance risk exposure.

Area of Focus #1: Understanding the Cost Elements of Examinations

The cost elements of market conduct examinations fall into five general categories:

1. Examination penalties
2. Costs of information gathering and analysis
3. Examiner per diems
4. Data requests
5. Post-examination remediation

1. Examination Penalties

Fines and penalties are the most visible indicator of market conduct noncompliance. They can be significant, as the recent examples of state fines in Table 1 demonstrate.

Compounding the bottom-line effects of monetary penalties is the negative publicity and brand erosion that accompanies them. A firm with negative exam outcomes is exposed to additional risk in the form of potential loss of current and future business.

Jurisdiction	Issues	Penalty
New York	Compliance issues associated with the administration of the Healthy NY program	\$750,000
New York	Replacement and application processes	\$1,900,000
California	Disability insurance claims handling violations	\$600,000
Texas	Failure to pay clean claims in a timely manner and to provide certain mandated coverages to insureds	\$500,000
Florida	Automobile claims handling issues	\$260,000
Connecticut	Multiple findings of licensing and rating errors, improper claim denials, and record retention violations in commercial and personal lines policies	\$235,000
Maryland	Multiple findings, including failure to supply clear and specific cancellation reasons and policy nonrenewals based on inquiries that did not result in a claims payment	\$175,000
Pennsylvania	Noncompliant adverse action notices	\$50,000

Table 1. Recent state examination penalty examples.

The Financial Impact of Effective Market Conduct Examination Management

2. Costs of Information Gathering and Analysis

The adage “an ounce of prevention is worth a pound of cure” certainly applies to market conduct examinations. If an insurer maintains an awareness of the hot issues that states are addressing in examinations, then the firm can take steps to ensure compliance where those issues before it undergoes an examination.

Gathering compliance information and identifying regulator concerns requires considerable research and analysis of state examination activity—critical actions that can represent a substantial internal resource cost. Furthermore, production and accessibility of exam documents varies from state to state. Knowing how to access this information across all jurisdictions is definitely not a “turnkey” operation, but rather one that involves costly, ongoing, one-on-one contact with market conduct staff in many states. Table 2 estimates the costs associated with the acquisition and analysis of examination activity information for all lines of business.

3. Examiner Per Diem

Even if an exam results in no fines or penalties, insurers must still pay per diems, lodging and meal charges for each on-site examiner. For example, Pennsylvania’s recently published per diem fees, as of July 1, 2010, is presented below:

Market Conduct Examination Staff	Per Diem
Examiner Trainee	\$285
Examiner 1	\$379
Examiner 2	\$506
Examiner 3	\$490
Examiner Manager	\$627

Over the course of an exam, these costs can skyrocket. An average-sized carrier can expect four on-site examiners during a typical three-month exam, carrying a per diem expense tag of more than \$115,000. That cost does not take into account meals and housing for examiners.

4. Data Requests

Fulfillment of examiners’ data requests prior to and during the exam can present significant cost-control opportunities:

- Failure to provide required documents will likely result in penalties and fees.
- Delays in providing the documents delay the exam’s completion—resulting in higher examiner fees.
- Resource costs associated with supporting the examination process—including researching, compiling and fulfilling data and other requests from regulators—is lost opportunity cost for company staff dedicated to performing those functions.

Furthermore, a firm’s exam managers must grasp not only the scope of the actual data requests, but also the file formats that examiners require in order to maximize efficiency in the review process. Engaging corporate information technology staff in the exam process at the outset, even before examiners step on-site, can reap rewards in terms of cost savings. Insurers that take advantage of the states’ standard lead time for data requests (typically 30-60 days) exemplify a “best practices” approach to market conduct exam management.

On the other hand, failure to provide the format-correct data requested in advance of the exam, as well as failure to establish requested access to company systems at the commencement of the exam, could cause weeks of delays. Factoring in an average per diem of \$450 for a four-examiner team, a three-week delay in providing the requested data in the usable format can cost upwards of \$25,000 in additional costs. Truly, time is money.

Market Conduct Action Acquisition Costs

Cost per person-hour for sourcing of new market conduct actions:	\$35
Person-hours spent sourcing new actions (Assumes 2 people @ 5 hours/week):	520
Total annual cost of sourcing new market conduct actions:	\$18,200
Market Conduct Action Analysis Costs	
Cost per person-hour for analyzing actions to identify and document regulator concerns: ..	\$45
Person hours spent (Assumes 2 people @ 35 hours/week):	3,640
Total annual cost of market conduct action analysis:	\$163,800
Total Market Conduct Action Acquisition and Analysis Costs:	\$182,000

Table 2. Estimated annual examination acquisition and analysis costs

5. Post-Examination Remediation

Examinations will often result in corrective actions or other remediation steps. These necessary, high-priority actions require additional resources and can divert attention and energy from previously planned strategic initiatives. Consequently, they come at a premium cost to the organization.

It is easy to see how the fines, penalties and direct expenses of a single examination can reach hundreds of thousands—or even more

than a million dollars. Table 3 presents all the types of costs insurers should consider when evaluating the overall financial effect of market conduct exams on their organizations.

Armed with an accurate picture of the costs their organizations face, insurers can explore cost mitigation techniques that target specific stages of the examination process.

External Hard Costs	Internal Hard Costs	Soft Costs
Examiner Per Diem	Pre-Exam Research	Loss of Business Due to Compromised Brand
Examiner Travel/Housing	Fulfillment of Data/Information Requests	Opportunity Costs
Direct Penalties	Corrective Action Management	Increased Number of Complaints
	Exam Outcome Negotiations	Increased Risk of Court Actions
	Management Overhead	

Table 3. Market conduct examination costs

Area of Focus #2: Effectively preparing for future examinations

Knowing what to expect in advance allows a firm to get its compliance house in order.

Insurers can take steps to improve their examination management performance even before they learn they'll be subject to an exam. The best place to start is simply to ask, "What are the top compliance issues found by regulators in the jurisdictions that could examine us?"

With insight into the specific issues that regulators have focused on in past exams, a firm can prioritize its efforts and be fully prepared if an examination is called.

For example, a review of examination results over the past several years, see Table 4, across all jurisdictions reveals that criticisms tended to fall primarily in claims, followed by underwriting, and to a lesser degree agent licensing and advertising. Within each of these areas, examination reports exposed key compliance issues ranging from timeliness and notice content requirements to record retention and licensing.

A closer analysis of 4th quarter 2009 market conduct activity reveals a number of common issues in all jurisdictions. The most prevalent issues were found in the claims area across all lines of business:

- Overall claims criticisms for property and casualty lines of business generally fell into three areas: non-compliant claimant notices, inadequate delay notices to claimants, and failures to provide disclosures and maintain required documentation.
- Life and health lines of business showed similar trends, led by claims issues such as failure to acknowledge, pay, or deny claims within specified time frames. Other principal issues included failure to adhere to grievance and appeals requirements, and inadequacies in disclosure documents such as Explanation of Benefits () notices.

Proactively addressing these areas through internal compliance audits can improve examination results, mitigate negative outcomes, and potentially reduce associated penalties. In the event of an examination, such advance preparation can substantially reduce the length of the exam and the costs and resources dedicated to the process, while increasing the probability of a more favorable outcome.

2009 4th Quarter Market Conduct Criticisms		
Line of Business	Compliance Area	Number of Criticisms
P&C	Claims	328
P&C	Underwriting	265
P&C	Licensing	53
L&H	Claims	190
L&H	Underwriting	91
L&H	Licensing	21

Table 4. Focus of market conduct examinations

The Financial Impact of Effective Market Conduct Examination Management

Key states deserve special attention.

Insurers can further bolster their compliance efforts by understanding the issues of concern in the major states where they do business. At its best, this state-focused preparation encompasses two initiatives:

1. Staying up-to-date about states' examination activity. Insurers would be well advised to understand the key points from all examinations issued by their major jurisdictions. For example, in the first quarter of 2010 Pennsylvania issued the criticisms in Table 5, which represent just a few of those included in market conduct exams for all lines of business.

2. Maintaining records that key states will want in a format that is acceptable and usable by them. Information gathering can be a disruption to a business, especially when done on a rush basis when an examination is getting started. Such "catch-up" work leaves a firm at risk of producing data that is inadequate, error-prone or both. If certain documentation is requested in all or most exams that the company may be subject to, a standing repository of readily-available reports would save time and expense.

Company Area	Criticism
Claims	Denial of coverage for the two claims noted is not in compliance with the laws governing mandated benefits.
Claims	Failed to provide timely status letters for the 12 claim files noted.
Claims	Applicable sales tax on the replacement cost of a motor vehicle shall be included as part of the replacement value.
Claims	Failed to include a fraud statement on an automobile accident report.
Underwriting	Cancelled for other than permitted reasons.
Underwriting	Failed to provide the insured with a fix-it letter.
Underwriting	85 files did not contain evidence that a written disclosure was provided.
Underwriting	Company did not provide the signed rejection form of stacked limits for uninsured and underinsured motorists coverage.
Forms	Department form approval could not be established for {50} conversion application; file noted did not contain the required 45-day "free look" statement.
Licensing	Failed to file a notice of appointment and submit appointment fees to the Department.

Table 5. Key issues found in Pennsylvania 1st quarter 2010 market conduct examinations


At its best, state-focused preparation encompasses two initiatives: Staying up-to-date about states' examination activities and maintaining records that states will want in an acceptable format.



Area of Focus #3: Controlling costs during in-process examinations

Each phase of an examination offers opportunities for a firm to control or reduce costs.

Phase	Major Exam Manager Activities	Cost Control Opportunities
<h3>Exam Preparation</h3>	<ul style="list-style-type: none"> ■ Receive data requests from state. ■ Communicate scope of exam to business units. ■ Coordinate responses to questionnaires or interrogatories with business units, management, and legal staff. ■ Make arrangements for on-site accommodations, data access, company IT staff accessibility, and other examiner support needs. ■ Report to management on expected exposure to fines/remediation. 	<ul style="list-style-type: none"> ■ The following actions support completion of exams within the timeline originally conveyed by the regulators, thus minimizing the per diem team costs. ■ Review and respond to data requests as early as possible. ■ Dedicate resources to fulfilling data requests and monitoring responses for quality. ■ Provide exam team adequate physical facilities and read-only access to company computers to promote efficient exam process.
<h3>Examiners on Site</h3>	<ul style="list-style-type: none"> ■ Conduct initial exam conference with examiners, review expected timeline, engage examiners in company systems training, provide list of authorized company personnel. ■ Respond to inquiries and criticisms throughout the exam. ■ Follow through on requests for information from business units. ■ Coordinate with legal and executive management as needed. ■ Report on exam status and progress. 	<ul style="list-style-type: none"> ■ Obtain company-wide commitment to process improvement. ■ Provide accurate, format-correct information to exam team from introduction to data fulfillment. Examiners will be more likely to fulfill their exam timeline and examiner time on-site—and associated costs—will be minimized.
<h3>Examination Wrap-Up</h3>	<ul style="list-style-type: none"> ■ Present all mitigating factors that the state exam team should consider. 	<ul style="list-style-type: none"> ■ Immediately and proactively implement corrective actions for issues uncovered during an exam. Lower fines may result. ■ Provide reasoned explanations of apparent deviations from the expected norm. This can reduce the financial impact of negative findings.
<h3>Examination Outcome Negotiation</h3>	<ul style="list-style-type: none"> ■ Review exam report and work with business units to prepare response. ■ Ensure timelines are met and the organization achieves most favorable outcomes. ■ Demonstrate to the examiners the immediacy of the corrective actions already implemented throughout the on-site exam period. 	<ul style="list-style-type: none"> ■ Efficiently respond and proactively address of noncompliance findings, with the aim of mitigating fines for the current exam. ■ Demonstrating such a proactive approach to compliance can also minimize the regulator’s need to re-exam on a targeted basis, thus foregoing those costs associated with more frequent exams. ■ To the extent proactive efforts are made, a firm can minimize future consumer complaints. When complaint ratios and trends improve, an insurer can face a reduced risk of selection for future exams.



Examiners are extremely likely to conduct a targeted re-examination to confirm that required changes were implemented and that they remain in effect.

Keys to Success – Post-Examination

With the conclusion of market conduct exams come the stipulations or orders. These typically include corrective action plans that provide detailed steps that state regulators require as conditions for full satisfaction of the order.

Corrective action implementation provides an opportunity to invest in improved future performance. Examiners are extremely likely to conduct a targeted re-examination to confirm that required changes were implemented and that they remain in effect

over time. Should targeted exams reveal continuing noncompliance, additional monetary penalties, and more frequent re-exams with stricter supervision could result.

Insurers can enhance the effectiveness of the post-exam phase through the concerted efforts of market conduct management and audit personnel. Market conduct management staff will ensure that the corrective actions are implemented, and audit personnel can verify at later dates

that “de-implementation” has not occurred. Even if specific corrective action plans are not stipulated following an exam, organizations can—and should—take advantage of all opportunities for improvement that an exam may uncover.

How Wolters Kluwer Financial Services can help

Market Conduct examination management is a multi-faceted responsibility that requires a variety of different skills, knowledge and talents to be effective and successful. Wolters Kluwer Financial Services enhances insurers' ability to control costs and reduce risks of noncompliance in four ways:

1. Enabling effective internal compliance reviews

Considering the varying requirements of all jurisdictions and lines of business, compliance audits can seem overwhelming. Wolters Kluwer Financial Services provides automatic and continuous examination activity updates that allow insurers to easily select the jurisdictions and issues that present their greatest exposure to a negative regulatory finding. Using this time-saving functionality to quickly access compiled compliance "intelligence," firms can optimally devote resources to compliance auditing.

2. Delivering informed responses during the course of an exam

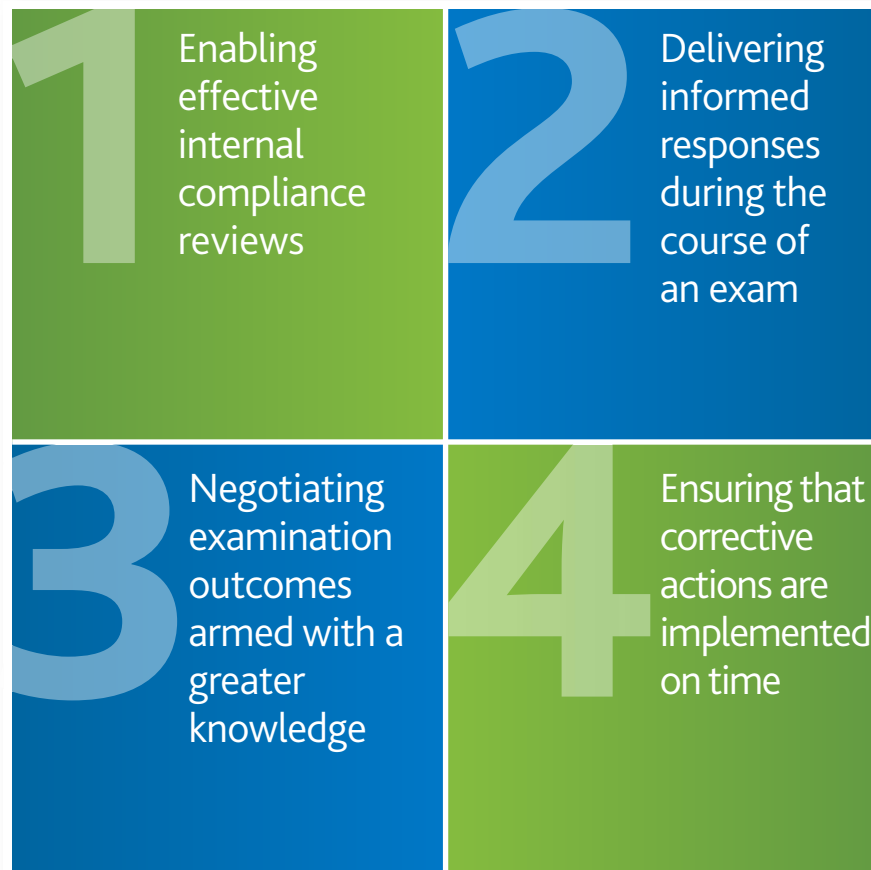
When faced with inquiries and criticisms during an exam, insurers can respond confidently when they understand the enforcement history associated with specific laws and regulations. Products from Wolters Kluwer Financial Services allow examination professionals to easily determine the examination history of every legal citation that examiners use to enforce state requirements.

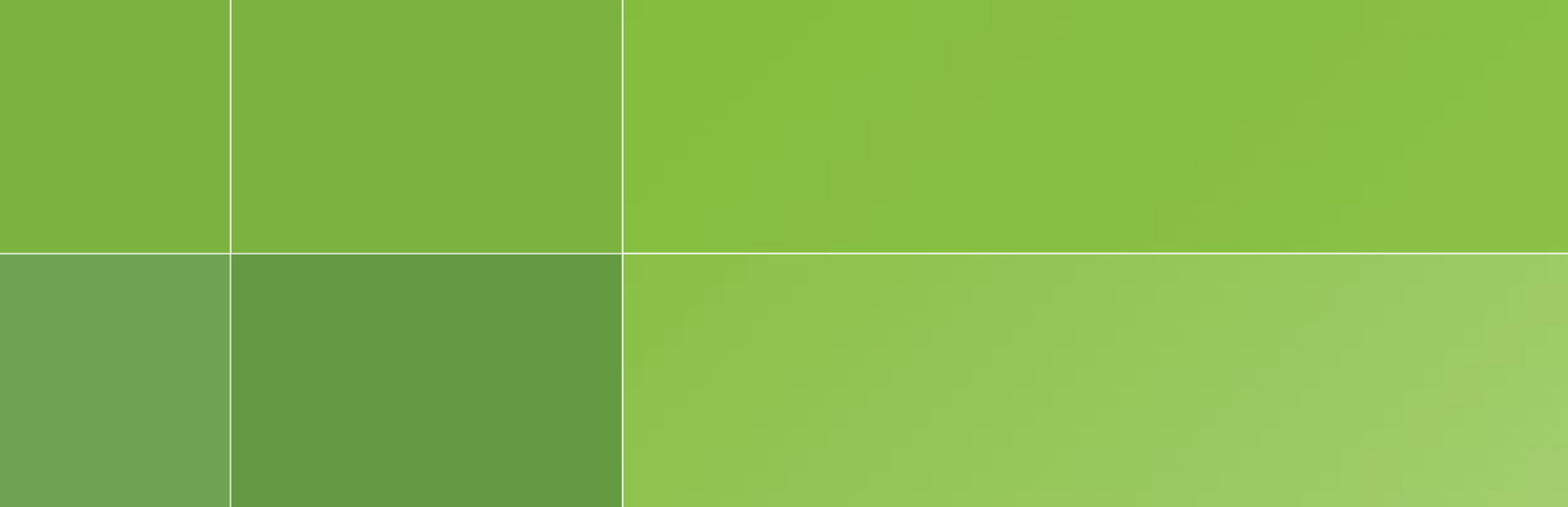
3. Negotiating examination outcomes armed with greater knowledge

When an insurer understands how a jurisdiction has concluded previous examinations, the firm can have greater leverage as examination reports are finalized. Wolters Kluwer Financial Services enables insurers with this valuable insight.

4. Ensuring that corrective actions are implemented on time

Assigning responsibility for executing corrective actions—plus the continuous monitoring of those actions—are key business capabilities required to prevent repeat compliance violations. Wolters Kluwer Financial Services provides the business process management tools insurers need to master this process.





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