

**GAO**

**Testimony**

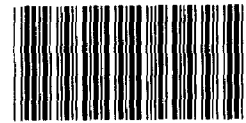
Before the Subcommittee on Oversight and Investigations  
Committee on Energy and Commerce  
House of Representatives

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**INSURANCE  
REGULATION**

**The National Association of  
Insurance Commissioners'  
Accreditation Program  
Continues to Exhibit  
Fundamental Problems**

Statement of Richard L. Fogel  
Assistant Comptroller General



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INSURANCE REGULATION:  
The National Association of  
Insurance Commissioners' Accreditation  
Program Continues to Exhibit Fundamental Problems

Summary of Statement by  
Richard L. Fogel  
Assistant Comptroller General

GAO supports state efforts to improve the quality and effectiveness of insurance solvency regulation. States have attempted to make improvements by adopting the Financial Regulation Standards set forth in NAIC's accreditation program. NAIC's standards have been a catalyst in some states to make improvements in insurance regulation.

In each of the last three years, GAO has assessed NAIC's efforts to sustain and standardize insurance solvency regulation. In 1991, GAO expressed serious doubts about NAIC's ability to create and maintain a national regulatory system. These doubts stemmed from NAIC's lack of authority to require states to adopt and enforce its standards. On the basis of three accreditation reviews completed at that time, GAO reported that the Financial Regulation Standards were not specific and that the accreditation review process had procedural weaknesses.

Last year, GAO testified that NAIC's accreditation program results did not distinguish effective from ineffective regulation for three reasons. First, the Financial Regulation Standards were, for the most part, general and had been interpreted permissively by accreditation review teams. Second, the review teams' documentation did not consistently support compliance decisions. Finally, the accreditation program had too little focus on implementation of the standards--that is, how well a state insurance department actually did its job.

Although there have been some improvements in documentation in the third year after its inception, these three problems with NAIC's accreditation program persist. On the basis of reviewing 10 states accredited in 1992, GAO identified several concerns related to NAIC's persistent problems, among them:

- permissive interpretation of NAIC's standards without criteria for evaluating what is "substantially similar" to the accreditation requirements;
- growing resistance by some regulators, state legislators, and industry representatives to the demands of the accreditation program; and
- inadequate criteria for evaluating states' financial analysis processes.

Nevertheless, NAIC's efforts allowed GAO to identify a disturbing pattern of weak financial examination processes in accredited states.

GAO supports NAIC's goal of trying to continually improve state insurance regulation through the accreditation process. GAO also recognizes that no regulatory scheme or accreditation approach is going to be perfect. Judgment must always come into play in how decisions are made regarding the adequacy of the regulatory operations of an organization. While inherent limits in NAIC's ability to enforce standards and rules raise doubts about its ultimate ability to achieve effective state regulation, NAIC's efforts are worthwhile.

GAO's primary concern with the process is the speed with which NAIC is moving with the accreditation process and its willingness to develop clear standards and apply them rigorously. GAO believes that in the interest of assuring adequate solvency regulations, it is important to move as quickly as possible to bring all appropriate regulatory bodies up to minimum levels of accepted operational standards. The quicker NAIC is willing to improve its accreditation process, the better chances are to achieve effective solvency regulation under the current state system.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here once again to discuss the efforts of the National Association of Insurance Commissioners (NAIC) to improve and standardize solvency regulation of those companies that provide insurance to individuals and businesses across this country.

In each of the last 3 years, you have asked us to evaluate the capability of NAIC to create and maintain an effective national system for solvency regulation. NAIC has attempted to achieve its goal of a state-based, nationally consistent system of solvency regulation first by defining the Financial Regulation Standards, the set of minimum standards that it believes are necessary for effective solvency regulation, and then by accrediting those departments that meet those standards. We are here today to provide our assessment of the accreditation program's success as a mechanism for establishing a real minimum regulatory standard and for credibly identifying states that are effective regulators of solvency.

We have observed and monitored NAIC's accreditation program since its inception. We have interviewed NAIC staff on many occasions and reviewed documents that described the program's objectives and procedures. For each of the states that have been accredited, we have reviewed documents provided by the insurance department to support its application for accreditation, NAIC documents assessing the readiness of the department to be reviewed for accreditation, and the workpapers and associated documents prepared by NAIC's review team which evaluated the department's compliance with the Financial Regulation Standards. We also observed the NAIC accreditation review of two state insurance departments: Illinois in 1991 and Oklahoma in 1993.

NAIC has generally cooperated with our reviews of its program, although NAIC did request that we not publicly identify individual states. Letters and memos relating to NAIC's concern about confidentiality are found in appendix I. Nevertheless, we were given access to all accreditation review workpapers and related documents. Although we were permitted to photocopy only the final reports of the review teams, we could make handwritten notes from other workpaper documents. NAIC has not permitted us to attend closed meetings of the Financial Regulation Standards and Accreditation Committee where accreditation decisions were made. NAIC informed us that no minutes were prepared for several recent accreditation meetings, including the meeting in March of this year during which the committee considered withdrawing the accreditation of three previously accredited states. As a result, we were unable to fully assess the decision process that led to withdrawing the accreditation of one state--New York--and not withdrawing the accreditation of the other two--Florida and Wisconsin.

Our fieldwork this year was done at NAIC's Kansas City headquarters and at the Oklahoma Insurance Department between January and April 1993. In accordance with our procedures, we have met with NAIC staff and officers several times over the past 3 years to discuss our findings and to verify the accuracy of the information we obtained.

#### PROBLEMS WITH NAIC ACCREDITATION PROGRAM PERSIST

When we testified before this Subcommittee on May 22, 1991,<sup>1</sup> we expressed serious doubts about NAIC's ability to create and maintain an effective national system for insurance solvency regulation. Our doubts stemmed from NAIC's lack of authority to require states to adopt and enforce its standards. We did not believe NAIC could be granted the broad authority it would need, either by the states or by the federal government. On the basis of the three accreditation reviews completed at that time, we also testified that the Financial Regulation Standards were not specific and that the accreditation review process had procedural weaknesses.

Last year, we testified that NAIC's program was not yet a credible mechanism for indicating that a state insurance department adequately regulated within its borders.<sup>2</sup> The accreditation program was experiencing three problems. First, the Financial Regulation Standards were, for the most part, general and had been interpreted permissively by accreditation review teams.<sup>3</sup> Second, the accreditation program had too little focus on state insurance departments' implementation of regulatory authorities and required practices--that is, how well a state insurance department actually does its job. Third, documentation of accreditation reviews did not consistently support compliance decisions.

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<sup>1</sup>Insurance Regulation: Assessment of the National Association of Insurance Commissioners (GAO/T-GGD-91-37, May 22, 1991).

<sup>2</sup>Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners (GAO/T-GGD-92-27, Apr. 9, 1992).

<sup>3</sup>In June 1989, NAIC adopted a set of Financial Regulation Standards that each state insurance department must comply with in order to be accredited. There are 27 standards on laws and regulations, 12 standards on regulatory practices and procedures, and 6 standards covering organizational and personnel practices. Seven of the standards on laws and regulations were added to the Financial Regulation Standards in March 1993. More information on the standards and the accreditation program can be found in appendix II.

We continue to support NAIC's objective of improving the quality and consistency of solvency regulation and believe its accreditation program has helped to improve the overall quality of state regulation. We also recognize that a new program will inevitably experience unanticipated problems and that a learning curve can be expected as changes are adopted to improve the program. Since we testified last April, 10 additional state insurance departments have been accredited, bringing the total number of states that have been accredited to 19.<sup>4</sup> NAIC plans to complete 20 more accreditation reviews by the end of this year.

While NAIC's standards have been a catalyst in some states to make improvements in insurance regulation, our concern with the process is the speed with which NAIC is moving and its willingness to develop clear standards and apply them rigorously. NAIC's accreditation program still does not convincingly demonstrate that accredited states can effectively regulate insurer solvency.

First, NAIC has made some improvements this year in the program documentation, but the documentation is still too inadequate to fully explain the basis for accreditation decisions. That is, in most instances, there was little documentation explaining why variations from NAIC models and deficiencies in regulatory practices and procedures still met the standards.

Second, what the documentation does show is that permissive interpretation of general standards continues to allow states with weak regulatory authorities and practices to be accredited. The Financial Regulation Standards are the heart of the accreditation program. NAIC has publicly characterized the Financial Regulation Standards as "stringent" and stated that accreditation of a state signifies it has demonstrated "a high level of performance." Our observations indicate, however, that the accreditation program has, so far, failed to establish a meaningful and definable minimum level of solvency regulation.

Finally, NAIC has acknowledged that the accreditation program needs to look more closely at how well a state insurance department performs its regulatory function. However, NAIC does not plan to make immediate changes to its program because it does not want to impose a different standard on the remaining

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<sup>4</sup>The 10 state insurance departments that were accredited during 1992 are Alaska, Colorado, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Texas, Utah and Virginia. In March 1993, NAIC suspended New York's accreditation certificate for failing to enact several required laws or regulations. A complete list of accredited states is found in appendix III.

unaccredited states. Instead, NAIC has begun revising its accreditation procedures to take effect when the second round of full on-site accreditation reviews begin in late 1995. In our opinion, the reason for this delay is not compelling. In any case, we do not know what new procedures NAIC is planning or whether the revisions will resolve the problems that we have identified.

On the basis of our work this year, we would like to amplify four areas of concern, each related to the problems that we have consistently identified since the accreditation program began. First is the failure of NAIC to make the standards more specific, allowing permissive interpretation and application. Second, there are growing indications that resistance to the accreditation program is likely to limit its long-term sustainability. Third, we have seen further evidence that states with weak financial examination processes for assessing solvency are being accredited, despite the fact that examination quality is nearly the only area in which the accreditation program currently attempts to evaluate the states' performance as regulators. Finally, the criteria for assessing the quality of financial analysis performed in accredited states are inadequate.

STANDARDS ARE NOT SPECIFIC, ALLOWING  
PERMISSIVE INTERPRETATION

For the accreditation program to be credible, it must establish consistent minimum standards that apply to each accredited state. NAIC and its review teams, however, continue to interpret the Financial Regulation Standards permissively. Therefore, states with weak regulatory authorities and practices are being accredited.

For example, most of the standards on laws and regulations require the state insurance department to have a particular NAIC model or authorities that are "substantially similar." In most instances, NAIC has not specified criteria for determining whether state variations from NAIC models actually provide the minimum level of solvency regulation intended by the standard. NAIC has said that these determinations are left primarily to the judgment of the review teams and ultimately the Financial Regulation Standards and Accreditation Committee. NAIC's President has said that this creates a problem for the review teams as well as for the committee. We are concerned that liberal interpretation of what is "substantially similar" to the NAIC models specified in the standards allows inconsistent or inadequate regulation.

Our review of the accreditation documentation revealed that all of the accredited states had variations from the NAIC models. Sometimes the states lacked model provisions, and sometimes the language of provisions was simply different from that of the NAIC



models. In other cases, states had provisions not found in NAIC models; sometimes these provisions were stricter than the models but other times appeared to negate the intent of the models. Without specific criteria defining "substantially similar," we could not assess whether the teams' or the committee's determinations were appropriate or consistent. In light of the many variations cited by the review teams, we question whether the accreditation program will result in uniform, or even consistent, solvency regulation as NAIC envisions.

NAIC is trying to make several of the accreditation standards more specific. These include the standard for minimum capital requirements and the standard requiring that a state have a guaranty fund. We do not know when or if these changes will be adopted. However, in our view, NAIC failed in its much publicized attempt to clarify one of the financial regulation standards. In October 1991, NAIC ruled that, to become accredited, states had to have a particular provision of the Model Insurance Holding Company System Regulatory Act precisely as it was stated in the model. This particular language, setting the threshold for extraordinary dividend payments requiring regulatory approval, was added to the model law in 1986. This provision was added following the failure of Baldwin-United where, according to regulators, the parent holding company milked the insurance subsidiaries to service its own debt. By the time that NAIC made its decision to require the specific model language, several states with weaker thresholds than the model had already been accredited. Subsequently, NAIC reversed its ruling requiring the stricter threshold and approved a number of alternative provisions that it will accept as "substantially similar." According to NAIC, this action was taken because it believed that requiring only the model provision was "too rigid". However, some industry analysts have characterized NAIC's acceptance of the alternatives as weakening the standard. (See appendix IV for a fuller discussion of the controversy over the extraordinary dividend provision.)

We are concerned that liberal interpretation of what is accepted in the accreditation program as "substantially similar" may allow significant variation among states and potentially weak regulatory performance rather than a consistent and definable floor in state systems for solvency regulation.

#### GROWING RESISTANCE TO DEMANDS OF ACCREDITATION PROGRAM MAY LIMIT ITS SUSTAINABILITY

According to NAIC, the accreditation program is dynamic, and standards will be added or amended to keep pace with changing industry practices. The evolutionary nature of NAIC's accreditation program will require states to periodically adopt new authorities or amend their regulatory programs to maintain their accredited status. For example, states have until January

1, 1996, to comply with seven new standards recently adopted by NAIC. Given the nature of the state-based insurance regulatory system, changes in the accreditation program require each state to revisit issues already addressed and considered resolved by its state legislature. We continue to question whether NAIC can sustain its program over time because it lacks authority to require states to adopt and use its standards.<sup>5</sup>

Many state insurance departments are still working to adopt the original standards and may not be able to keep pace with NAIC's ever evolving standards. (Appendix V provides information on the current status of the states' adoption of the NAIC models required for accreditation.) In March of this year, New York--one of the first states to be accredited--had its accreditation suspended by NAIC for failing to adopt several model laws or regulations added to the original standards. Recently, a number of regulators, industry representatives and state legislators have expressed resistance to NAIC's efforts to clarify vague standards and add new ones. Opposition from these participants in the regulatory process raises further doubts about the long-term viability of the program.

LACK OF FOCUS ON PERFORMANCE ALLOWS STATES WITH WEAK EXAMINATION QUALITY TO BE ACCREDITED

Insurance regulators have two tools that they routinely use to monitor insurers' financial condition and identify solvency problems. These are on-site examinations and off-site analyses of insurer-reported financial information. The accreditation documentation we reviewed revealed a disturbing pattern of weaknesses in the way states do insurance company examinations--a fundamental regulatory function. We found that NAIC's review teams consistently identified deficiencies in states' examination systems. This is troubling because examinations, which are generally required only every 3 to 5 years, are the principal means that state regulators have to verify insurer-reported data and to detect financial problems.

In our review of states accredited in 1991, we found numerous instances in which the review teams' workpapers appeared to indicate clear noncompliance with the regulatory practices and procedures standards on examinations. For example, some state insurance departments did not examine insurers in a timely fashion, and some did not have the necessary and required specialists available to assist examiners. Several states also

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<sup>5</sup>Some states now require by law that except under certain conditions, examination reports prepared by nonaccredited states not be accepted beginning in January 1994. The effect of this sanction on an individual state's decision to apply for accreditation is uncertain.

did not comply with the accreditation requirement that they follow the policies and procedures of NAIC's Examiners Handbook. Nevertheless, the review teams certified departmental compliance with NAIC's standards as acceptable for accreditation, despite these noted deficiencies.

Again this year, the review teams' documentation suggested that minimum capabilities and procedures necessary for effective examination processes were not truly in place in all accredited states. In 7 of the 10 states accredited during 1992, the documentation indicated that examinations did not generally follow the Examiners Handbook in areas crucial for solvency monitoring. While the extent of the problems varied among the states, the accreditation review teams found inadequate testing of policy and loss reserves, lack of comprehensive internal control assessments, and reliance on unverified insurer-produced data and on the work of insurers' external auditors without assessing the quality and reliability of the auditors' work. (See appendix VI for specific examination weaknesses found by accreditation review teams in several of the states accredited in 1992.)

With these documented weaknesses in insurance company examinations, we question the state regulators' abilities to effectively detect solvency problems. Without proper assessment of insurance reserves, examiners have no reliable basis to understand an insurer's primary business operation. Without comprehensive assessments of internal controls, regulators have little assurance that examinations will detect all major control weaknesses. As a result, regulators could fail to find problems before they seriously erode an insurer's financial condition. Using unverified data and the work of external auditors without reviewing the scope and quality of that work also increases the risk that examiners will not detect potential problems.

These procedural weaknesses are exacerbated by a lack of quality controls over the consistency and reliability of examiners' work. The review teams often found inadequate documentation of what examination work was performed. They also found little explanation about why certain work was not performed. Both findings indicated to the teams that supervisory review was lacking or inadequate. Without proper documentation and supervisory review of work performed, there is a high likelihood that errors in examiner judgment could go unchallenged and that incorrect conclusions could result.

In testimony before this Subcommittee last year, NAIC said that it does not accredit states on a conditional basis. But, in reality, it had already done so. In 1991, Iowa was accredited on the condition that it was to demonstrate compliance with the regulatory practices and procedures standards during the year following its accreditation. In 1992, 3 of the 10 newly

accredited states--Texas, North Dakota, and Minnesota--received accreditation contingent once again upon a full on-site reevaluation of their compliance with the regulatory practices and procedures standards in 1 year.

Texas was recommended for accreditation by the review team, and the committee accredited the state on the condition that Texas improve how it did financial analysis and financial examinations. Specifically, Texas was told to conduct its financial analysis on a more timely basis and implement more comprehensive examination procedures. North Dakota received accreditation but the review team believed it was only "minimally acceptable" with respect to its use of specialists and its compliance with the Examiners handbook. The review team in Minnesota recommended accreditation but also characterized the state's compliance with the examiners Handbook and supervisory review standards as "minimally acceptable." The review team further recommended that Minnesota's accreditation be withdrawn in 1 year unless it could demonstrate "significant improvement" in its compliance with those standards.

Under NAIC's scoring system, the need for significant improvement to comply with a standard is the definition of a failing score. Furthermore, according to the accreditation procedures, a state can become accredited only if it successfully meets or exceeds all minimum accreditation standards. A state failing to meet any minimum accreditation standard cannot be accredited.

If these three states met the requirements for accreditation, why were they accredited for only 1 year? If they did not meet the requirements, why were they accredited at all? Given the review teams' documentation, the stated criteria of the accreditation program, and NAIC's own recognition that these states did not comply fully with the requirements for accreditation, we question the NAIC's decision to accredit these states.

Last year, we suggested that NAIC consider recognizing publicly a qualified or conditional accreditation status for states which are found not to be in full compliance on all standards and, thus, are not prepared for full accreditation. NAIC's current policy is to publicly announce full accreditation for each state, but NAIC did not publicly disclose that four states' accreditations were contingent on passing another full on-site review in 1 year after their accreditations. The difference between these two alternatives may appear to some to be merely semantic. However, if NAIC is to hold up its program as a basis for assuring the public that the states are doing a good job of regulating the industry, it should be willing to share publicly the results of its assessments of state efforts. Public sharing of this information also could be a catalyst for making improvements.

## CRITERIA ARE INADEQUATE FOR ASSESSING THE QUALITY OF FINANCIAL ANALYSIS

Insurance departments also assess an insurance company's financial condition through analysis of insurer-provided financial information. Like examinations, financial analysis is a component of NAIC's standards and the accreditation review process. However, whereas NAIC's Examiners Handbook contains specific work procedures and guidelines for planning, supervising, and conducting examinations, similar procedures or guidelines that could be used as criteria in assessing how well a state insurance department analyzes insurer financial statements do not exist. As a result, we are unable to determine what constitutes an acceptable level of performance for the financial analysis process.

Because the scoring for each of the regulatory practices and procedures standards is not independent, the limited criteria for financial analysis is a significant concern. That is, although the program specifies that a state must receive a passing score on each standard, NAIC told us that weaknesses in one area can be offset by perceived strengths in other areas. In fact, as we reported last year, NAIC said that examination weaknesses in one accredited state were not a problem because the state had a good financial analysis system.

## CONCLUSIONS

We support state efforts to improve the quality and effectiveness of insurance regulation through adoption of the Financial Regulation Standards set forth in NAIC's accreditation program. We believe that NAIC's standards have been a catalyst encouraging state insurance departments to regulate better.

So far, however, the program still does not credibly distinguish effective from ineffective solvency regulation. The standards are applied permissively. Thus, accreditation does not establish a meaningful minimum level of performance. Nevertheless, NAIC's accreditation review teams' efforts reveal a troubling pattern--poor quality of examinations in accredited states. These examinations are critical for effective solvency regulation. As long as the standards for accreditation of state insurance departments are vague and liberally interpreted, NAIC will not achieve uniformity, or even consistency, in state-by-state regulation. Moreover, we continue to question NAIC's ability to successfully sustain the program over the long term without the inherent authority to enforce its standards.

We recognize that no regulatory scheme or accreditation approach is going to be perfect. Judgment must always come into play in how decisions are made regarding the adequacy of the regulatory operations of an organization. While inherent limits in NAIC's

ability to enforce standards and rules raise doubts about its ultimate ability to achieve effective state regulation, we believe NAIC's goal of achieving a national system of insurance solvency regulation is worthwhile.

However, our primary concern with the process is the speed with which NAIC is moving with the accreditation process and its willingness to develop clear standards and apply them rigorously. We believe that in the interest of assuring adequate solvency regulations, it is important to move as quickly as possible to bring all appropriate regulatory bodies up to minimum levels of accepted operational standards. The quicker NAIC is willing to improve its accreditation process, the better chances are of achieving effective solvency regulation under the current state system.

Mr. Chairman, this concludes my prepared remarks. We will be pleased to answer questions.

Correspondence About Confidentiality**GAO**United States  
General Accounting Office**Memorandum**

**Date:** December 18, 1992

**To:** Director of Research, NAIC - Bob Klein

**From:** Jack Strauss, GAO *for TS*

**Subject:** Initial Request for Documentation

Per our discussion, we would like to have the following documents in order to begin our work.

--The current accreditation review interlineations as well as those used in the accreditation reviews performed since the April 1992 hearing should they differ.

--Review guide/work plan for accreditation review teams.

--Accreditation reports, compliance reports, and management letters for states accredited since April 1992 and similar documentation for the Iowa follow-up review.

--Written guidance/bulletins to unaccredited states and any similar guidance to accredited states relative to interim annual reviews and reaccreditation.

--Interim annual submissions received from accredited states.

--Description of any changes to the financial regulation standards and effective dates.

--Description of changes/enhancements to the accreditation process (If not already available we can be briefed on this later).



Operations Improvement

Correspondence About Confidentiality

Lastly, we plan to update the status of the states' adaption of the model laws and regulations contained in the standards. As in our previous work, we will work with your legal staff to do this work.

We will call you should we require any additional information. Please call me on (202) 275-2651 if you have any questions or need to talk further about our work.

Thanks for your cooperation and assistance. Our address is:

U.S. General Accounting Office  
441 G Street, N.W.  
Room 5715  
Washington, DC 20548



Correspondence About Confidentiality**NAIC**120 West 12th Street  
Suite 1100  
Kansas City, Missouri 64105-1925  
816-842-3600816-471-7004 Main Fax  
816-842-9185 Financial Services & Research FaxNational  
Association  
of Insurance  
Commissioners

January 14, 1993

Mr. Lawrence Cluff  
U.S. General Accounting Office  
General Government Division  
Washington, DC 20548

Dear Larry:

This letter is in response to Jack Strauss' December 18, 1992 memo to Bob Klein requesting materials related to the National Association of Insurance Commissioners' (NAIC) accreditation program. We understand that these materials are being requested as part of a follow-up U.S. General Accounting Office (GAO) review of the NAIC's accreditation program. We are happy to cooperate with the GAO, as we have in the past, in any way we reasonably can to facilitate a thorough and objective evaluation of the accreditation program.

With respect to documents GAO requested that are not specific to a particular state, we have enclosed the following:

- Accreditation Reference Manual
  - accreditation review interlineations
  - review guide/workplan
  - guidelines for unaccredited states, interim annual review and reaccreditation.
- Additions to the NAIC Financial Regulation Standards

With respect to documents GAO requested that are specific to a particular state (e.g., compliance reports, workpapers, etc.) the NAIC feels strongly that the identities of specific states should not be publicly disclosed together with the information contained in the documents. Unfortunately, information of this nature that was shared previously in confidence with the GAO was disclosed in a public hearing last year, resulting in unnecessary embarrassment to the states that were named.

It is important to note here that the NAIC does not object to your review of these documents. Indeed, in order to perform a thorough and objective evaluation of the accreditation program, we believe that you should review these documents. But we do object to public disclosure of state's identities with respect to these documents.

Correspondence About Confidentiality

We believe that the accreditation program must be given every chance of success. While an objective evaluation of the program is relevant to, and in furtherance of, its success, public disclosure of an individual state's identity together with information contained in the documents is not. We believe that public disclosure of these documents with individual states identified could have serious consequences that could place the program in jeopardy.

Public disclosure would embarrass states needlessly and could discourage continued participation in the accreditation program and cooperation with the NAIC.

Further, public disclosure could chill the completion of complete and objective management letters written by the independent accreditation audit team. If the teams are aware that their reports may be used for purposes for which they were not intended, then they may censor their own reports.

We doubt that there is any intention on your part to contribute in any way to hindering the success of the accreditation program. Therefore, we seek your advice in discussing with us how we can make the accreditation documents that specifically name a state available to you for your review and evaluation, and at the same time not make the states' identities public.

Please contact me or Bob Klein if you have any questions about these materials. We look forward to hearing from you.

Sincerely,



David B. Simmons  
Executive Vice President

KTC/RWK/DBS:ls

Enclosures

cc: Steven Foster	Ed Dinkel
David Walsh	Kevin Cronin
William McCartney	Bob Klein
Darren Cook	Jack Strauss, GAO

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Correspondence About Confidentiality**GAO**

United States  
General Accounting Office  
Washington, D.C. 20548

General Government Division

March 30, 1993

David B. Simmons  
Executive Vice President  
National Association  
of Insurance Commissioners  
120 West 12th Street, Suite 1100  
Kansas City, MO 64105-1925

Dear Mr. Simmons:

As you know, the General Accounting Office has been requested to do another evaluation of the National Association of Insurance Commissioners' program for accrediting states that meet the NAIC's Financial Regulation Standards. This request comes from Chairman John Dingell of the Oversight and Investigation Subcommittee of the House Committee on Energy and Commerce.

In your letter of January 14, 1993, you expressed concern about the confidentiality of some of the information we must review in order to satisfy Chairman Dingell's request. Specifically, you stated:

With respect to documents GAO requested that are specific to a particular state (e.g., compliance reports, workpapers, etc.) the NAIC feels strongly that the identities of specific states should not be publicly disclosed together with the information contained in the documents.

We understand your concern about confidentiality, particularly in a program that depends for its continued existence on the voluntary participation of individual states. At the same time, accredited states are identified publicly by the NAIC. Since you have presented accreditation as proof of the states' ability to meet a minimum level of regulatory capability, it is appropriate that the basis for, and fairness of, accreditation decisions be as widely known and understood as possible. Such disclosure is essential, as the program's ultimate success depends on its credibility. Indeed, your letter recognizes the necessity of "... a thorough and objective evaluation of the accreditation program."

GAO is unable to provide a guarantee of confidentiality such as you have requested in this case. Nor did we provide such a guarantee last year when we reviewed the accreditation

Correspondence About Confidentiality

program. The Subcommittee has requested, both this year and last, that GAO provide a full assessment of the accreditation program. In our written statement last year, we did not associate individual states by name with the accreditation review teams' findings about their regulatory capability and performance. However, in questioning, Chairman Dingell and other Subcommittee members requested that the states be identified. It is possible that similar information will be requested by the Subcommittee this year as well, and we are obligated to respond. A guarantee of confidentiality, or an agreement not to ask for specific information, could only be provided with the agreement of the Subcommittee itself.

Therefore, unless we are informed by the Subcommittee that they have agreed not to ask for certain information, you should assume that the information you provide to us could be made public at the discretion of the Subcommittee. This would undoubtedly also include information relating to the decisions made at the Nashville Meetings to suspend the accreditation of New York and not to suspend those of Florida and Wisconsin, as well as our observations of the recessed accreditation review of the Oklahoma Department.

We at GAO appreciate the cooperation that you have given us in the past as we have attempted to describe and assess the insurance regulatory system. As a result of that cooperation, the Congress has a better understanding of how the system works and of both its strengths and its weaknesses. Such an understanding is essential as we all work to ensure that the important issue of insurer solvency is effectively addressed.

Sincerely yours,



James L. Bothwell  
Director, Financial Institutions  
and Markets Issues

cc: Steven Foster, NAIC  
Kevin Cronin, NAIC  
Bob Klein, NAIC  
Jack Chesson

THE ACCREDITATION PROGRAM'S  
STANDARDS AND REVIEW PROCESS

NAIC's financial regulation standards were adopted in June 1989 and fall into three categories:

- First, there are twenty-seven Part A standards covering laws and regulations, seven of which were added by NAIC in March 1993. State insurance departments have until January 1, 1996 to comply with these new standards. According to NAIC, the Part A standards address whether the state insurance department has the needed authority to regulate an insurer's corporate and financial affairs. These standards cover such things as regulatory authority to examine firms, minimum required capital levels, prescribed accounting practices, and appropriate corrective actions for troubled companies.
- Second, there are twelve Part B standards covering regulatory practices and procedures. According to NAIC, these standards address whether the state insurance department has the necessary resources and capabilities to conduct financial analysis and examinations of firms operating within the state.
- The third part of the program consists of six Part C standards covering organizational and personnel practices. According to NAIC, these standards address whether a state insurance department has professional development and minimum educational requirements for its staff that will promote effective regulatory practices.

In June 1990, NAIC adopted its accreditation program to encourage states to implement the standards. In a full accreditation review, an independent on-site team of about five individuals assesses the state insurance department's compliance with these standards. The on-site visits generally last about 5 days. Subsequent on-site re-accreditation reviews are to be scheduled every 5 years with annual off-site evaluations by NAIC in the interim. To attain accreditation, a state insurance department must

- have authorities through laws, regulations, or administrative practices that substantially comply with Part A standards;
- have sufficient resources and appropriate procedures and practices to comply with each of the part B and part C standards, as measured by a rating of at least "acceptable" on a rating scale of "excellent," "good," "acceptable," and "unacceptable"; and

-- receive an average score of "good" or better for the Part B standards taken together and for the Part C standards taken together.

To date, there is no penalty, other than peer pressure, for being an unaccredited state. However, beginning in January 1994 accredited states, except under certain circumstances, will not accept examination reports prepared by nonaccredited states on those states' domiciled insurance companies. This could require companies domiciled in nonaccredited states to get a second examination performed by an accredited state insurance department. This still does not penalize the unaccredited state directly. NAIC expects this sanction to lead insurers to lobby their home states to become accredited in order to avoid the expense of multiple examinations under differing state rules.

State Insurance Departments  
Accredited by the NAIC

State	Date accredited	Date accreditation withdrawn
1. Florida	12/90	
2. New York	12/90	03/93
3. Illinois	06/91	
4. South Carolina	06/91	
5. Iowa	12/91*	
6. Kansas	12/91	
7. North Carolina	12/91	
8. Ohio	12/91	
9. Wisconsin	12/91	
10. Colorado	06/92	
11. Minnesota	06/92*	
12. North Dakota	06/92*	
13. Virginia	06/92	
14. Alaska	12/92	
15. Missouri	12/92	
16. Nebraska	12/92	
17. New Hampshire	12/92	
18. Texas	12/92*	
19. Utah	12/92	

\*Accreditation was contingent upon a full on-site reevaluation of compliance with the regulatory practices and procedures standards in one year.

The Controversy Over the Treatment of  
Extraordinary Dividends for Accreditation

In 1991, NAIC took steps to clarify what it would accept as substantially similar for a state to be in compliance with the accreditation standards regarding the extraordinary dividend provision of the Insurance Holding Company System Regulatory Act. In October 1991, NAIC ruled that states must adopt verbatim, the language contained in the NAIC model. The provision sets a threshold for extraordinary dividend payments requiring regulatory approval. For life and health companies, regulatory approval is required for transactions that exceed the lesser of 10 percent of surplus as regards policyholders or net gain from operations. For property and casualty companies, regulatory approval is required for dividends that exceed the lesser of 10 percent of surplus as regards policyholders or net income not including realized capital gains.

The fundamental purpose of the prior approval requirement under the model act is to prevent an insurer from depleting its capital and significantly weakening its financial condition by paying excessive dividends. The model act does not prohibit payment of dividends defined to be extraordinary. It simply requires prior approval by the insurance commissioner subject to a 30-day deemer provision. If the commissioner determines that a proposed dividend defined to be extraordinary under the model act is in fact reasonable and would not be injurious to the insurer's financial health, the commissioner may approve the dividend.

By the time that NAIC made the decision to require strict adherence to the "lesser of" definition, several states that did not have this language had already been accredited. According to NAIC, in April 1993, 29 states, including 11 of the accredited states, did not satisfy this provision. Many states retained a previous model definition which contained the old "greater of" definition rather than the "lesser of" found in the current model standard.

Critics of the "lesser of" definition have argued that language substantially more liberal than the "lesser of" standard should be considered acceptable for compliance with NAIC's financial regulation standards. According to NAIC, insurance industry representatives have criticized the "lesser of" threshold for extraordinary dividends as an unreasonable and unnecessary restriction on a subsidiary insurer's ability to pay dividends to its parent holding company. The "lesser of" provision was added to the model act in 1986 following the failure of Baldwin-United where, according to regulators, the parent holding company "milked" the insurance subsidiaries to service its own debt. At



the time of the Baldwin-United failure, the NAIC model act required regulatory approval for dividends that exceeded the greater of 10 percent of surplus or net gain from operations, essentially the opposite of the revised model.

According to NAIC, the decision to require strict compliance with the "lesser of" provision for accreditation was met with protests not only from the insurance industry but from regulators and legislators as well. Accordingly, and in recognition of the divergence among the states, NAIC then reversed its ruling requiring strict adherence with the model provision, and instead, adopted eight alternatives which it will accept as being substantially similar to the "lesser of" provision. Also, according to NAIC, the alternatives were developed ". . . to provide comfort and predictability to insurers by detailing what commissioners would consider when approving or disapproving an extraordinary dividend as defined in the model act." States have until October of this year to comply with the model or one of the so-called substantially similar alternatives. It is interesting to note that six states which already complied with the "lesser of" definition have adopted or are considering adopting "greater of" language now deemed to be substantially similar. It is possible that other states will do the same.

Some industry analysts have characterized NAIC's adoption of the dividend alternatives as weakening the standard. However, NAIC's official position is that the alternative provisions and related requirements do not diminish a state's regulatory control over dividend payments. In spite of this, NAIC's own staff analyses of the alternatives pointed out that an inherent problem with the "greater of" definition was that it potentially allowed insurers to deplete large amounts of capital through dividends by artificially inflating net income. Moreover, when NAIC recently considered establishing criteria for determining appropriateness for approval of extraordinary dividends, the working group charged with this task by the Special Insurance Issues Committee found that the current "lesser of" language is appropriate and that this conclusion is supported by NAIC's own data. A past president of NAIC, who was a member of the working group reported that all of the industry proposed alternatives to the current "lesser of" definition would significantly increase the amount of dividends that would be payable without prior approval.

Finally, a number of consumer groups including the Consumers Union and the Consumer Federation of America believe that a move back to the "greater of" definition will create an unwarranted risk to insurance consumers. According to the consumer groups, a report prepared for them and subsequently submitted to NAIC in November 1992, showed that the change back to the "greater of"

definition would "double the maximum amount of dividends that insurers could pay out in good years to parent holding companies" as well as "maintaining those dividends even in bad years."

Table 1: Summary of States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

NAIC MODEL	Date Model Adopted by NAIC	Number of States With		
		Model/Similar Legislation or Regulation	Related Legislation or Regulation	No Current Legislation or Regulation
Examination Authority	1991	26	25	0
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	1985	28	3	20
Holding Company Act	1969	49	2	0
Holding Company Regulation	1971	38	7	6
Credit for Reinsurance Act	1984	39	9	3
Credit for Reinsurance Regulation (1)	1991	5	4	42
Regulation for Life and Health Reinsurance Agreements (2)	1986	29	1	21
Standard Valuation Law (1)	1943	51	0	0
Actuarial Opinion and Memorandum Regulation (1)	1991	6	3	42
CPA Audit Regulation (1)	1980	29	8	14
Rehabilitation and Liquidation Model Act	1978	29	22	0
IRIS Model Act	1985	35	6	10
Risk Retention Act	1983	45	2	4
Business Transacted w/Producer Controlled P/C Insurer Act (3)	1991	37	0	14
Managing General Agent Act	1989	44	1	6
Reinsurance Intermediaries Act	1990	37	1	13
Life and Health Insurance Guaranty Association Act	1971	50	1	0
Post-Assessment Property and Liability Insurance Guaranty Association Act	1970	44	7	0

**LEGEND:**

- (1) States have until January 1996 to adopt.  
(2) California is the only state to enact a more comprehensive version of this model adopted by NAIC in 1992. States have until January 1996 to adopt the new version.  
(3) States have until June 1993 to adopt.

Table 2: Summary of States With Legislation or Regulations Pending Related to  
NAIC Accreditation Models (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>Date Model Adopted by NAIC</u>	<u>Number of States With</u>	
		<u>Changes to Legislation or Regulation Pending</u>	<u>Initial Legislation or Regulation Pending</u>
Examination Authority	1991	2	6
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	1985	0	3
Holding Company Act	1969	13	0
Holding Company Regulation	1971	4	1
Credit for Reinsurance Act	1984	3	2
Credit for Reinsurance Regulation (1)	1991	0	4
Regulation for Life and Health Reinsurance Agreements (2)	1986	1	3
Standard Valuation Law (1)	1943	4	0
Actuarial Opinion and Memorandum Regulation (1)	1991	0	4
CPA Audit Regulation (1)	1980	2	0
Rehabilitation and Liquidation Model Act	1978	1	2
IRIS Model Act	1985	1	3
Risk Retention Act	1983	4	2
Business Transacted w/Producer Controlled P/C Insurer Act (3)	1991	2	7
Managing General Agent Act	1989	2	5
Reinsurance Intermediaries Act	1990	2	9
Life and Health Insurance Guaranty Association Act	1971	7	0
Post-Assessment Property and Liability Insurance Guaranty Association Act	1970	3	0

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Table 3: States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

NAIC MODEL	STATE					
	AK	AL	AR	AZ	CA	CO
Examination Authority	M	R	M	R	M	M
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	M	*	M	R	*	M
Holding Company Act	M	M/P	M	M	M	M
Holding Company Regulation	M	M	M	M	M	M/P
Credit for Reinsurance Act	M	M	M	M	M	M
Credit for Reinsurance Regulation (1)	*	*	*	*	*	R
Regulation for Life and Health Reinsurance Agreements (2)	M	M	M	*	M	*
Standard Valuation Law (1)	M	M	M	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	*	*	R	*	P	M
CPA Audit Regulation (1)	*	*	M	M	R	M/P
Rehabilitation and Liquidation Model Act	M	R	R	R	R	M
IRIS Model Act	R	*	M	M	M	M
Risk Retention Act	R	P	M	M	M	M
Business Transacted w/Producer Controlled P/C Insurer Act (3)	*	P	M	M	M	M
Managing General Agent Act	M	P	M	M	M	M
Reinsurance Intermediaries Act	M	P	M	M	M	M
Life and Health Insurance Guaranty Association Act	M	M/P	M	M	M	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	R	M	R	M

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R: Enacted Related Legislation/Regulation

P: Pending Legislation/Regulation

\*: No Action To Date

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Table 3: States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

NAIC MODEL	STATE					
	CT	DE	DC	FL	GA	HI
Examination Authority	M	R	R	R	R	R/P
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	M	M	*	*	*	P
Holding Company Act	M	M	M	M	M	M/P
Holding Company Regulation	R	M	M	*	M	*
Credit for Reinsurance Act	M	M	R	R	M	M
Credit for Reinsurance Regulation (1)	M	*	*	*	*	*
Regulation for Life and Health Reinsurance Agreements (2)	R	M	*	*	*	*
Standard Valuation Law (1)	M	M	M	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	P	*	*	P	*	*
CPA Audit Regulation (1)	M	R	*	M	*	R
Rehabilitation and Liquidation Model Act	M	R	R	R	M	M
IRIS Model Act	M	M	*	R	M	M
Risk Retention Act	M	M	*	M	M	M/P
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M	M	*	M	M	M
Managing General Agent Act	M	M	*	M	M	M
Reinsurance Intermediaries Act	M	M	*	M	M	M
Life and Health Insurance Guaranty Association Act	M	M	M	M	M	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M	M	R	M

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Table 3: States' Adoption of NAIC-Models Related to Accreditation (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>STATE</u>					
	<u>IA</u>	<u>ID</u>	<u>IL</u>	<u>IN</u>	<u>KS</u>	<u>KY</u>
Examination Authority	M	M	M	M/P	M	R
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	M	*	R	*	M	M
Holding Company Act	M/P	M	M/P	M/P	M	M
Holding Company Regulation	M	M	M	M	M	M
Credit for Reinsurance Act	M	M	M	R	R	M
Credit for Reinsurance Regulation (1)	M	*	*	R	*	*
Regulation for Life and Health Reinsurance Agreements (2)	M	*	*	M	M	M
Standard Valuation Law (1)	M	M	M	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	*	*	M	*	*	*
GPA Audit Regulation (1)	M	*	M	M	M	M
Rehabilitation and Liquidation Model Act	M	M	R	M	M	M
IRIS Model Act	M	R	M	R/P	R	M
Risk Retention Act	M	M	M	M	M	M
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M	M	M	P	M	M
Managing General Agent Act	M	M	M/P	M	M	M
Reinsurance Intermediaries Act	M	M	M/P	M	M	M
Life and Health Insurance Guaranty Association Act	M	M	M	M	M	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M/P	M	M	M

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Table 3: States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>STATE</u>					
	<u>LA</u>	<u>MA</u>	<u>MD</u>	<u>ME</u>	<u>MI</u>	<u>MN</u>
Examination Authority	M	R	R	R	R	M
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	*	*	*	P	M	M
Holding Company Act	M	M	M/P	M	M	M
Holding Company Regulation	M	M	M	M	R	M/P
Credit for Reinsurance Act	M	R	R	M	*	M
Credit for Reinsurance Regulation (1)	*	*	*	P	*	*
Regulation for Life and Health Reinsurance Agreements (2)	M	*	M	*	*	M
Standard Valuation Law (1)	M	M	M	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	*	*	*	*	*	M
CPA Audit Regulation (1)	M	M	R	R	M	M/P
Rehabilitation and Liquidation Model Act	R	R	R	M	M	M
IRIS Model Act	M	*	*	M	M	M
Risk Retention Act	M	*	M	M	M	M/P
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M	*	M	M	*	M
Managing General Agent Act	M	*	M	M	M	M
Reinsurance Intermediaries Act	M	*	P	M	*	M
Life and Health Insurance Guaranty Association Act	M	M	M/P	M	M	M/P
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M	M	R	M

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Table 3: States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>STATE</u>					
	<u>MO</u>	<u>MS</u>	<u>MT</u>	<u>NC</u>	<u>ND</u>	<u>NE</u>
Examination Authority Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	M	M	R/P	M	M	M/R/P
Holding Company Act	M	M	M/P	M	M	M
Holding Company Regulation	M	M	*	M	M	M
Credit for Reinsurance Act	M	M	M/P	M	M	M
Credit for Reinsurance Regulation (1)	M	*	*	*	*	*
Regulation for Life and Health Reinsurance Agreements (2)	M	M	*	M	M	M
Standard Valuation Law (1)	M/P	M	M	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	R	*	*	*	*	*
CPA Audit Regulation (1)	M	M	*	M	*	M
Rehabilitation and Liquidation Model Act	M	M	M/P	M	M	M
IRIS Model Act	M	*	P	M	M	M
Risk Retention Act	M	M	M/P	M	M	M
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M	M	P	M	M	M
Managing General Agent Act	M	M	P	M	M	M/P
Reinsurance Intermediaries Act	M	M	P	M	M	M/P
Life and Health Insurance Guaranty Association Act	M	M	M/P	M	M	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M/P	M	M	M

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Table 3: States' Adoption of NAIC-Models Related to Accreditation (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>STATE</u>					
	<u>NH</u>	<u>NJ</u>	<u>NM</u>	<u>NV</u>	<u>NY</u>	<u>OH</u>
Examination Authority	M	R/P	M	R	R	R
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	M	M	M	*	*	M
Holding Company Act	M	M/P	M	M	R	M
Holding Company Regulation	M	*	M	R	R	M
Credit for Reinsurance Act	M	P	M	R	M	M
Credit for Reinsurance Regulation (1)	M	*	*	*	R	*
Regulation for Life and Health Reinsurance Agreements (2)	M	*	*	*	M	M
Standard Valuation Law (1)	M	M	M	M	M/P	M
Actuarial Opinion and Memorandum Regulation (1)	*	*	*	*	R	*
CPA Audit Regulation (1)	*	M	*	R	R	M
Rehabilitation and Liquidation Model Act	M	M/R	R	R	R	M
RIS Model Act	M	P	M	R	*	M
Risk Retention Act	M	P	M	M	M	M
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M	P	M	*	M	M
Managing General Agent Act	M	P	M	M	R/P	M
Reinsurance Intermediaries Act	M	P	M	*	R/P	*
Life and Health Insurance Guaranty Association Act	M	M	M	M	M/R	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M	M	R	M/P

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R: Enacted Related Legislation/Regulation

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Table 3: States' Adoption of NAIC-Models Related to Accreditation (May 12, 1993 NAIC Information)

NAIC MODEL	STATE					
	TN	TX	UT	VA	VT	WA
Examination Authority	R	R	R	M	M	R/P
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	*	M/R	*	M	P	M
Holding Company Act	M/P	M	M	M	M	M/P
Holding Company Regulation	*	M	M	M	M/P	M
Credit for Reinsurance Act	M/P	M	M	M	M	R
Credit for Reinsurance Regulation (1)	*	P	*	M	*	*
Regulation for Life and Health Reinsurance Agreements (2)	*	M	M	M	P	M
Standard Valuation Law (1)	M	M	M	M	M	M/P
Actuarial Opinion and Memorandum Regulation (1)	*	M	*	M	*	*
CPA Audit Regulation (1)	*	M	*	M	M	M
Rehabilitation and Liquidation Model Act	M	R	M	R	M	R/P
IRIS Model Act	M	M	M	M	M	M
Risk Retention Act	M	M	M	M	M	M/P
Business Transacted w/Producer Controlled P/C Insurer Act (3)	M/P	*	M	M	M	P
Managing General Agent Act	M	M	M	M	M	P
Reinsurance Intermediaries Act	P	M	M	M	M	P
Life and Health Insurance Guaranty Association Act	M	M	M	M	M/P	M/P
Post-Assessment Property and Liability Insurance Guaranty Association Act	M	M	M	M	M	M

**LEGEND:**

M: Enacted Model/Similar Legislation/Regulation

R: Enacted Related Legislation/Regulation

P: Pending Legislation/Regulation

\*: No Action To Date

(1) States have until January 1996 to adopt.

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Table 3: States' Adoption of NAIC Models Related to Accreditation (May 12, 1993 NAIC Information)

<u>NAIC MODEL</u>	<u>STATE</u>		
	<u>WI</u>	<u>WV</u>	<u>WY</u>
Examination Authority	R	R/P	M
Regulation to Define Standards and Commissioner's Authority for Companies in Hazardous Financial Condition	*	M	M
Holding Company Act	R	M/P	M
Holding Company Regulation	R	*	M
Credit for Reinsurance Act	*	M	M
Credit for Reinsurance Regulation (1)	R	*	*
Regulation for Life and Health Reinsurance Agreements (2)	*	M	M
Standard Valuation Law (1)	M	M	M
Actuarial Opinion and Memorandum Regulation (1)	*	*	*
CPA Audit Regulation (1)	M	M	*
Rehabilitation and Liquidation Model Act	M	R	R
IRIS Model Act	*	M	M
Risk Retention Act	R	M	M
Business Transacted w/Producer Controlled P/C Insurer Act (3)	*	M/P	M
Managing General Agent Act	M	M	M
Reinsurance Intermediaries Act	M	P	M
Life and Health Insurance Guaranty Association Act	R	M/P	M
Post-Assessment Property and Liability Insurance Guaranty Association Act	R	M	M

**LEGEND:**

M: Enacted Model/Similar Legislation/Regulation

R: Enacted Related Legislation/Regulation

P: Pending Legislation/Regulation

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Examination Weaknesses Identified By  
The NAIC's Accreditation Review Teams

NAIC's Part B standards for financial examinations require, in part, that a state insurance department follow the policy and procedures contained in NAIC's Examiners Handbook. To determine whether a state insurance department is in compliance with these standards, NAIC's on-site accreditation team reviews prior examination reports, supporting workpapers and analytical reviews. The following are excerpts from the accreditation review documentation for several states accredited during 1992. As the information shows, the extent of the weaknesses identified varied from state to state. These examples also suggest that tested and consistent processes and procedures were not truly in place in all accredited states.

Minnesota

- "The Division should adopt a formal policy which requires a more uniform process in performing an examination regardless of which EIC, or which examiner, performs the work. In all cases the work performed should meet the standards prescribed by the Examiners Handbook whether the procedures are performed by the examiners or are accepted by the examiners from the work of the CPA. It appears that, at present, an examination and its documentation depend more on the practice of the individual EIC than on standards imposed by the Chief Examiner or Deputy Commissioner."
  
- "The review of examination workpapers disclosed that there appears to be inconsistent use of the NAIC Examiners Handbook on examinations. On most examinations, there was little evidence of any planning performed, time budgets or assessment of materiality and risk with respect to particular accounts. On most examinations reviewed, there appeared to be substantial reliance on CPA workpapers, although the examiners did not appear to routinely test the CPA's work or document the reasons for or degree of reliance upon such work."
  
- "The Divisions's policy calls for all examination workpapers prepared by examiners to be reviewed by the examiners in charge (EICs), but workpapers prepared by the EICs were generally not reviewed by anyone. The quality of workpapers was inconsistent, depending on which EIC was in charge of the examination. Examiners do not routinely sign and date workpapers that they prepare. Evidence of supervisory review by the EIC of examiner-prepared workpapers was inconsistent from examination to examination and ranged from no evidence of review to location of the EIC's initials and a date on lead

sheets for each workpaper section. The Chief Examiner generally did not visit examination sites to review workpapers and address issues . . . ."

- "Prepared workpapers, including incorporated CPA workpapers, should be signed and dated by the examiner responsible for the area. The EIC should document his review of examiner and Division actuary workpapers. Workpapers prepared by the EIC should be reviewed, and this review should be evidenced by the Chief Examiner or his designee."
- "The Division has not directly used a computer audit specialist on examinations. The examiners did in some instances include within the examination workpapers CPA workpapers pertaining to the testing of insurer-generated computer data. The examination workpapers reviewed did not document examiners' reliance on portions of the CPA workpapers pertaining to testing of insurer-generated computer data. The Division has indicated that it is in the process of developing expertise and experience in this area."
- "The review team recommends that the Division proceed with its plans to provide EDP Internal Control evaluation training to its examiners. This training should enable examiners to document their evaluation of EDP control questionnaires or to incorporate CPA workpapers on EDP control in their examination planning. The training should also enable examiners to document the affect of EDP control on the scope of the examination procedures."
- "The Division has recently added a substantial number of examiners . . . . Because the newly hired staff have varied amounts and types of experience and have just recently been integrated into the examination process, it is difficult to ascertain to what extent the addition of the new staff will ultimately enhance the Division's procedures."
- "The Division has recently added a substantial number of financial analysis staff . . . . Because the newly hired staff have varied amounts and types of experience and have just recently been integrated into the analysis process, it is difficult to ascertain to what extent the addition of the new staff will ultimately enhance the analysis reviews. The Division in some instances appears to have had problems tracking work flow and assignments, apparently due in large part to a lack of staff in the past and, more recently, to the integration of the newly hired staff."

North Dakota

- "Workpapers fail to demonstrate reference to NAIC Examiner Handbook in many critical areas of examinations. Although inquiries and tests may have been made by examiners during course of the examination, it is important that workpapers document these steps . . . . Generally no evidence that examiner was properly supervised during the examination or that his work product was subject to review and signoff by Chief Examiner."
- "Overall, in theory sounds satisfactory with new procedures [examination] that have been put in place only a few months. Too early to see the system in operation other than a couple of the latest examinations." The team member further concluded that although "marked improvements in workpapers . . . still a long way to go."
- "Internal controls needs to be utilized more in planning. Need review of Examiner Handbook to insure all points covered. Need additional work on reserves, claim files, LAE (loss adjustment expenses), unreported claims, reinsurance files . . . . More documentation of findings is needed especially where there are exceptions."
- "No report planning memo, no formalized procedures, no indication of supervisory review, no budget projections or results . . . no schedule of workpaper files. Theoretically, and hopefully actually, these deficiencies will be remedied through the use of the new formalized procedures."
- "The Department is using a consulting life actuary for valuation and reinsurance expertise on its larger insurer examinations . . . . However, the review team cautions the Department that actuary participation (consulting) does not relieve them of overall responsibility for, and major participation in, the examination of these liabilities." The team also noted that the Department had never used a property/casualty actuary but had recently hired one.

Texas

- "Scope of audit not clearly established and other planning details appear lacking, including scheduling exam, time budgets and audit program development. Supervisory review by EIC appeared perfunctory, audit steps in most instances enumerated but not initialled and dated to indicate step or procedures performed. Examination procedures limited to balance sheet items. In absence of internal audit and system

- review some testing of operational practices should have been considered."
- "The Texas Examination Policy and Procedures Manual has recently been revised. In order to insure that newly instituted procedures are being implemented it is suggested that appropriate supervisors be required to determine and report on the progress of compliance by the examination staff."
  - "The NAIC Examiners Handbook provides an illustration of an internal control questionnaire that should be an integral part of examinations. It is recommended that the Department incorporate internal control questionnaires into its examination plans. Evaluation of internal controls should also include those controls associated with EDP systems, including sufficient testing of controls where warranted."
  - "Current Department examination planning procedures do not sufficiently address operating accounts. Further, the lack of written examination plans that assign responsibilities and allocate time budgets by tasks makes the monitoring of staff performance and progress of examinations more difficult."
  - "On Texas only examinations there was little evidence of adequate planning. Time budgets are not used except on an overall basis and there is no evidence of an assessment of risk in planning financial statement approaches . . . . The Accreditation Team also noted that examination teams did not conduct a review and evaluation of internal controls as required by the Handbook. The Department does assess materiality and evidence of this assessment was noted by the team."
  - "The Department's policy is for all examination workpapers prepared by examiners to be reviewed by the examiners in charge (EICs). Under a new procedure recently instituted, Assistant Chief Examiners are to review and initial lead sheets. However, the team was unable to review any examinations performed under this new procedure. Examiners do not generally sign and date examination workpapers nor was there evidence in the workpapers of the EIC review."
  - "Current balance sheet examination procedures should be supplemented with an analysis of operating trends in order to detect trends that may impact a company's future financial condition. Such an analysis is particularly relevant where a change in management or ownership of a company has occurred since that last examination."



Missouri

- "During the review of the workpapers, the team noted that it is the general practice of the Department not to examine underlying data supporting life policy inforce and property/casualty claim reserve data bases. Little, if any, time is budgeted for this work, there are few, if any, workpapers prepared, and the entire responsibility is apparently assumed to be that of the contract actuary. This is so even though the actuaries regularly disclaim responsibility for testing the accuracy of the data utilized by them. We have discussed this briefly with members of the Department during our review, and we understand that steps are being taken to initiate a formal program of procedures to be part of every examination. The team strongly supports such a program."
- "The team noted that in most of the files reviewed, the EDP Controls Questionnaire contained in the Examiner's Handbook and the Departments Examination Guide was not completed. It is recommended that the questionnaire be used on all exams utilizing EDP equipment."
- "During the review of the workpapers, the team noted in the scope and conclusion workpapers of one section of an examination the following comments: "This item was set aside because much information on the mortgage loans was missing from the files, and other items on the examination had to be worked on or completed. Therefore, this file is not complete because there was not enough time allocated to complete this item. . . . Although the item [mortgage loans] being examined was material to the balance sheet and constituted significant exposure in the examination, these workpapers survived two levels of review and remain as a part of the examination documentation. Similar comments were noted on other examinations with no indication of appropriate resolution. This would suggest that instructions to the field should be clarified and that supervision and review should be strengthened in order to insure that all areas of an examination be concluded and all significant examination concerns be resolved."

Nebraska

- "While it was represented to the review team that detailed audit programs followed NAIC Examiners Handbook guidelines, this was not evident in all of the workpapers reviewed. In particular, it was noted that the underlying data supporting insurance reserve was generally not tested by the examiners

- and an EDP control questionnaire was not completed on the examinations reviewed."
- "The review of workpapers noted instances where examiners appeared to rely on company-generated computer data without documenting a basis for such reliance. This was noted specifically in the areas of policy and loss reserves and unearned premium reserves."
  - "The review of workpapers noted two instances (one property/casualty company and one life company) where the completeness and accuracy of life insurance inforce and property/casualty loss development data was not sufficiently tested. The Examiner's Handbook contains detailed procedures that should be performed to test the accuracy and completeness of such data. This testing should be reviewed by the actuaries to ensure adequate testing coverage. The review team notes that this testing should be performed by financial examiners and not by actuaries."
  - "The review of workpapers noted that judgmental test samples and the resulting confidence levels obtained from such testing were not commensurate with the risk associated with the accounts tested. The result is test sample sizes that tend to be very small for premiums, insurance inforce, paid and reported unpaid losses and ceded reinsurance. Test sample sizes should be based on an assessment of the risk of material error that accounts can have on the solvency and financial condition of the insurer."
  - "While the review team noted initials on the workpapers to evidence supervisory review by the EIC of workpapers generated by the examiners, it was not clear how detailed the review was. Numerous instances were noted where examiners had not fully documented procedures performed by explaining tickmarks or by preparing written memoranda explaining conclusions reached. In some instances, there appeared to be open issues remaining in the workpapers even after the EIC's review. It is important that the EIC's review be an in-depth review challenging the procedures performed and conclusions reached by the examiner rather than a more cursory review."
  - "There was some evidence that EICs relied on CPA workpapers, but little evidence that they conducted internal control evaluations in planning the scope of examinations . . . . The Handbook provides an illustration of an internal control questionnaire that should be an integral part of examinations. It is recommended that the Department incorporate internal control questionnaires into all of its examination plans . . .

Evaluation of internal controls should also include those controls associated with EDP system computer applications."

- "Instances were noted where companies promised compliance with certain report on examination recommendations, but the same deficiencies were present at the time of the next examination. In such cases action should be taken to insure that remedial action is effected within a reasonable period, rather than awaiting the next examination to ascertain compliance."

#### New Hampshire

- "The review team noted that provisions of the Handbook were not used in all areas. For example, the team noted instances where the examiners appeared to rely on company-generated computer data without documenting a basis for such reliance."
- "Significant variation was noted in the level of examination review and supervision performed by EIC's between the New Hampshire-based and New York-based examination staffs . . . . The quality of workpapers varied somewhat depending upon the preparing examiner and was inconsistent between New Hampshire-based and New York-based examination staffs."
- "Current Department examination planning procedures do not sufficiently address operation accounts. Further, the lack of written examination plans that assign responsibilities and allocate time budgets by tasks makes the monitoring of staff performance and progress of examinations as a whole more difficult."
- "The review noted instances where the examiners appeared to rely on company-generated computer data without documenting a basis for such reliance. This was noted specifically in the areas of loss reserves and unearned premium reserves."
- "The Handbook provides an illustration of an internal control questionnaire that should be an integral part of examinations. It is recommended that the Department incorporate internal control questionnaires into all its examination plans. Evaluation of internal controls should also include those controls associated with EDP systems, including sufficient testing of controls where warranted;"
- "While the review team noted initials on the workpapers to evidence supervisory review by the EIC of workpapers generated by the examiners, it was not clear how detailed the review was. Numerous instances were noted where examiners had not fully documented procedures performed by explaining tickmarks

or by preparing written memoranda explaining conclusions reached. In some instances, there appeared to be open issues remaining in the workpapers even after the EIC's review."

### Utah

- "The Department should consider establishing more formal guidelines for the examiners to consider in following the procedures recommended by the Examiner's Handbook. This should include consideration of something comparable to the Handbook's Classification of Accounts in order to relate the extent of testing to the amount of exposure involved."
- "The Department should consider reviewing its policy with respect to examination report disclosures in relation to disclosures reported by the contract actuary. In one examination reviewed, the actuary expressed many concerns regarding aggregate life reserves even though no adjustment was recommended, and the examination report stated only that "no material exceptions to the Company's aggregate reserves were noted"."
- "The Department should consider establishing a policy requiring completion of each section of an examination to the satisfaction of the examiner-in-charge. In the review of one examination an instance was noted where the EIC indicated concerns about life policy in-force records but discontinued work 'because of timing constraints' with the additional comment that the Company's 'EDP records be more thoroughly reviewed in the subsequent examination.'"
- "The Department is contemplating a change to periodically visit examinations in progress to review workpapers of completed areas and assess the administration of the examination. The review team encourages this procedure and notes that in addition, it is important that this on-site review be an in-depth review challenging the procedures performed and conclusions reached by the examiner(s) . . . . In one instance, the working paper review was not completed even though the exam report had been issued because the EIC had left the area to participate in a zone examination. In other instances, the workpaper review was not completed until after the report was filed."

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