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MULTISTATE MARKET CONDUCT EXAMINATIONS: A STUDY OF PENALTIES AND PREDICTIONS

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Over the past decade, states have increasingly used a multi-state mechanism (the Market Actions Working Group, or "MAWG") developed through the National Association of Insurance Commissioners ("NAIC") to coordinate market conduct examinations of the insurance industry. Sometimes, the examinations result in penalties being imposed. Because MAWG penalties are ultimately enforced by individual states, it seems desirable, for both equitable and legal reasons, that MAWG impose penalties on a consistent basis with those employed by individual states. Accordingly, an examination of past state penalties can be instructive.

Using a subset of publicly-available data, we model certain penalties imposed by past individual state investigations, isolate consistently-relevant factors, and project penalty ranges in alternative, hypothetical scenarios. This analysis, while exploratory in nature, provides the groundwork for further analysis about the proportionality and consistency of potential future penalties proposed by MAWG.

Background

Until recent years, insurance companies primarily faced investigations into their sales practices on a state-by-state basis. This process too often ended up being inefficient for everyone: insurers faced duplicative and possibly inconsistent accusations from individual states, and states could face substantial burdens establishing cases unique to their policyholders.

To address these inefficiencies, the NAIC created the MAWG. Through its Collaborative Action Guidelines ("Guidelines") in its Market Regulation Handbook, the NAIC provides a process by which investigations can be initiated and consolidated by multiple states through MAWG against a particular insurer or group of insurers. The Guidelines assume that each investigation is led by a market conduct regulator from a Managing Lead State, or from one or more Lead States.[1] Other interested states, called Participating States, can join settlements proposed between the insurer and the Lead State(s), applying the terms of that settlement to their residents as well to the extent possible under that state's laws.

States are encouraged to join the multiple state examinations as Participating States, which confers enormous power on those states leading the examination. Of course, "with great power there must also come . . . great responsibility."[2] For instance, the Guidelines provide that a Managing Lead State can determine if there is a "state issue that is not an appropriate part of the MAWG collaborative action."[3] This determination is based on Participating States providing "interpretations of the Participating State's laws, if requested."[4] The assumption is that the Managing Lead State and the Participating States will account for possible statutory differences in determining areas subject to examination.

From a more practical perspective, the MAWG significantly increases the scope of investigatory exams. By encouraging more states to become Participating States, and join joint settlements, there are more jurisdictions to account for in the exam process than when exams were conducted on an individual state basis.[5] The Participating States are also encouraged to bring forward any additional issues they wish to be a part of the exam.[6] Consequently, insurance companies responding to a multiple state exam may experience a significant increase in scope in terms of both jurisdictions and issues covered. Companies may perceive this as leading to increased regulatory risk and operational burdens, based on the significant amounts of additional data and information that may be requested. Insurers may feel increased pressure to settle regardless of the merits of any underlying allegations that may pertain to the investigation, simply because of the volume of policyholders involved and impact on their business. While the proposed efficiency of a coordinated investigation is a worthy goal, the potential impact on the targeted company and the settlement multiplier generated by multi-state participation can have a forceful effect, and underscores the importance of treating similarly-situated insurers in a comparable fashion.

The law probably imposes constitutional restraints on MAWG Lead States' ability to impose penalties. Because insurance commissioners are state actors, they are subject to the constitutional restraints that proscribe inequitable state conduct. As

Mitt Romney reminded us, to his electoral detriment, "corporations are people" too.[7] These corporations, including insurance companies, are protected from arbitrary government action, and likewise are entitled to equal protection by the Fourteenth Amendment to the U.S. Constitution.[8] To be sure, the McCarran-Ferguson Act gives the states substantial latitude in the regulation of insurance. But as the U.S. Supreme Court has made clear, while "the McCarran-Ferguson Act exempts the insurance industry from Commerce Clause restrictions, it does not purport to limit in any way the applicability of the Equal Protection Clause."[9] Nor does the McCarran-Ferguson Act permit a state to impose its insurance regulation in an extraterritorial fashion.[10]

MAWG itself is an association, not a government entity. However, its findings are necessarily enforced by individual states, and MAWG-sponsored examinations are led by state commissioners. Thus, these constitutional limitations likely apply to penalties proposed through the MAWG process. Although we found no such published application of these principles to MAWG, there have been several informative decisions reached by federal courts concerning penalties issued by federal regulators. Federal agencies are bound by the Fifth, rather than the Fourteenth Amendment, but the due process and equal protection requirements are similar in principle.[11] For that reason, a review of federal precedent is useful.

Generally speaking, no party is entitled to the exact same penalty given to someone else by a government agency. Or, as the U.S. Supreme Court held, ''mere unevenness in the application of the sanction does not render its application in a particular case unwarranted in law."[12] However, courts have significantly reduced some penalties issued by regulators,[13] and the U.S. Court of Appeals for the D.C. Circuit has stressed that regulators have a duty to justify the unique circumstances supposedly necessitating an unusual penalty:

> [The] Commission must do more than say, in effect, petitioners are bad and must be punished. Petitioners do not stand alone; they are, alas, only two in a long line of enterprises and individuals who have seen fit to conduct themselves in violation of the law of the land. . . . Faced with a task of such gravity, the Commission must craft with care.[14]

In sum, MAWG regulators appear to have a duty to treat similarly-situated insurers in a similar manner. Insurance companies are not automatically entitled to the exact penalty provided to a previous insurer, and the MAWG retains discretion to make reasonable distinctions between materially different conduct. However, penalties that are clear outliers from earlier assessments risk judicial scrutiny and invalidation. Put another way, it behooves everyone involved in the market conduct regulation process to recognize and apply a consistent, rational system for assessing appropriate penalties.

Many of the decisions supplying these principles are decades old, and the tools to assess the connections between penalties have become far more sophisticated. Relationships that were largely theoretical in the 1980s can now be tested, confirmed, or rejected in seconds on modern computer hardware using generally-accepted statistical analysis. To take advantage of these advances, we propose an analytical model to look for patterns in selected penalties handed down by individual states in recent years.

To the credit of these states, the model suggests consistent connections between certain characteristics of the investigated insurers, the policies at issue, the extent of the conduct under investigation, and the size of the penalties that have been imposed. The model helps identify those relevant attributes, and predicts how they would extend to other investigational circumstances.

The Data

Penalties handed down by various states from 2009 through 2015 were located through a review of published consent decrees. Insurance company attributes were tabulated from information submitted in NAIC quarterly filings with the California Department of Insurance, the Pennsylvania Department of Insurance, and/or the Insurance Information Institute.

The data was filtered to focus only on penalties for which the following information could be determined:

1. The number of "instances" of misconduct alleged by the state;

2. The volume of gross written premiums for the insurer in question as reported during Quarter 3, 2014 to one or more states;

3. The average premium of the policies being investigated as reported to the Insurance Industry Journal in 2012;

4. The reported surplus (assets minus liabilities) of the insurer in question as reported to one or more states during Quarter 3, 2014;

5. The inflation adjustment for the calendar year of the penalty's imposition (using the Consumer Price Index).

The number of instances was chosen because it demonstrates the extent of the challenged conduct. The average premium was chosen to relate fines per violation to premiums per violation, serving as a proxy for determining penalties relative to a customer's cost. Finally, the reported surplus and volume of gross written premiums were considered because insurers are required to maintain financial stability, measured in part by a gross written premium to surplus ratio. This ratio could affect a state's assessment of the company's resources available for continued healthy operations, including the ability to prevent or provide remediation for an issue.

The states represented in the final penalty sample included, in declining order of frequency: Pennsylvania, Arizona, Washington, Minnesota, Missouri, and Oklahoma.

Matters involving worker's compensation insurance were removed entirely, as their premium structure is quite different from typical consumer policies. Other factors, such as the type of conduct being penalized, the identity of particular states, and insurer recidivism were not included as covariates in this pilot study. These and other factors deemed relevant to particular investigations can still be assessed, either for general applicability or to evaluate a particular, proposed penalty in the future.

After this screening process, there were 58 penalty outcomes available for modeling. All involved some type of penalty being imposed.

The Model

The outcome of interest, size of the penalty, was modeled with candidate covariates Instances, Gross Written Premiums, Average Premium at Issue, Consumer Price Index, and Surplus. All of these variables, both the response and covariates, have distributions that are heavily right-skewed and were subjected to a natural log transformation prior to modeling.

Several approaches were considered to model the most likely relationship between these predictors and the corresponding penalty imposed upon each insurer in the group. We found that a generalized additive model was an effective choice: its predictions correlated to the original penalties at a rate of over .9 (Pearson) after 500 repetitions of Monte Carlo cross-validation. Thus, our model explains over 80 percent of the variance among the penalties in our data set.

We employed the *mgcv* package in the R Computing Environment: all variables entered into the model with smoothing splines except for inflation, which was modeled linearly.

Results

The number of instances was highly statistically significant in predicting the fine (p<.001). Average premium and surplus had borderline significance (p ~ .1) and were retained because their coefficient values made sense (e.g., greater values corresponded generally with greater fines). Gross Written Premiums did not appear to offer additional value in predicting fines, and removing it from the model increased explanatory power. Thus, the final model considered only Average Premium at Issue, Instances, Surplus, and Consumer Price Index.

Applying the model back onto our original data, here are the predictions for insurers of the penalties properly imposed with various combinations of factors. The underlying values for these predictions are fictional, and were created for illustration purposes only. All values have been rounded to the nearest integer, and we assumed all penalties would be handed down in the current year, negating the need for any inflation adjustment:

Avg. Premium	Instances	Surplus	Pred. Fine
$600	5,000	$10 M	$55,894
$600	100,000	$10 M	$144,042
$600	5,000	$500 M	$79,156
$600	100,000	$500 M	$203,989
$1000	5,000	$10 M	$120,454
$1000	100,000	$10 M	$310,419
$1000	5,000	$500 M	$170,586
$1000	100,000	$500 M	$439,611

The "predicted fine" in this table is the average expected penalty for a given set of predictors. However, the average penalty by itself does not tell us everything we want to know. There are very few, if any "average" cases that split every predictor right down the middle. Moreover, the constitutional principles discussed above do not require identical penalties, only similar ones. Thus, we are interested not only in the mean predicted penalty, but the range of penalties around those means — a range that would incorporate the regulator's discretion to enhance or reduce the mean penalty, based on a good-faith assessment of associated circumstances.

We accomplish this by placing 95 percent prediction intervals around the predicted fines. Our chosen intervals will encompass, to a 95 percent likelihood, the expected penalty range for the predicted conduct. The intervals were chosen by adding a bootstrapped residual to each prediction, and taking average error for each such prediction. Adding these upper and lower bounds, the table expands as follows:

Avg. Premium	Instances	Surplus	Pred. Fine	Lower Bound	Upper Bound
$600	5,000	$10 M	$55,894	$15,301	$183,027
$600	100,000	$10 M	$144,042	$39,431	$471,674
$600	5,000	$500 M	$79,156	$21,669	$259,200
$600	100,000	$500 M	$203,989	$55,842	$667,977
$1000	5,000	$10 M	$120,454	$32,974	$394,436
$1000	100,000	$10 M	$310,419	$84,977	$1,016,489
$1000	5,000	$500 M	$170,586	$46,698	$558,594
$1000	100,000	$500 M	$439,611	$120,344	$1,439,535

Limitations

The data we modeled was selected because it contained complete information in our categories of interest. We excluded penalties for which we were missing any such information. It is possible the chosen data is not generally representative of state penalty tendencies, although our chosen modeling methods should be reasonably robust. The definition of "incidents" also must be applied consistently in the same manner as in these earlier investigations. It is also possible that additional factors we did not model (some of which were described above) could have a material impact on the size of an imposed penalty. These factors, if identified, could be separately researched and added to this or any other model. We also emphasized the importance of interpretability in choosing our model; it is possible that a more complex, even "black box" approach could yield more accuracy with increased information. Such adjustments, again, are easily made, particularly with sufficient data about any identified, additional predictors of interest.

Conclusion

The MAWG process presents an opportunity for both greater efficiency and effectiveness in regulating the insurance industry. However, participating NAIC members should strive to maintain a consistent approach across investigations when imposing penalties.

This article suggests a model to evaluate the process by which states have been imposing penalties to date, and to the credit of those states, it finds a consistent pattern in the features apparently associated with penalties imposed. Future work can involve alternative methods, additional or alternative data, and additional relevant predictors.

Notes

[1]. National Association of Insurance Commissioners ("NAIC"), *Market Regulation Handbook*, Volume 1 (2014 ed.).
[2]. *Kimble v. Marvel Entertainment, LLC*, No. 13-720 (June 22, 2015) (citing S. Lee and S. Ditko, Amazing Fantasy No. 15: "SpiderMan," p. 13 (1962)).
[3]. Market Regulation Handbook, 2014.
[4]. *Id.*
[5]. *Id.*
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[7]. Parker, Ashley. "'Corporations Are People,' Romney Tells Iowa Hecklers Angry Over His Tax Policy." *The New York Times*, August 12, 2011, p. A16, N.Y. edition. The article is available at http://www.nytimes.com/2011/08/12/us/politics/12romney.html?_r=0.
[8]. *Pembina Consolidated Silver Mining Co. v. Pennsylvania*, 125 U.S. 181, 189 (1888).
[9]. *Metropolitan Life Insurance v. Ward*, 470 U.S. 869, 880 (1985).
[10]. *FTC v. Travelers Health Ass'n*, 362 U.S. 293, 300-301 (1960).
[11]. *Hampton v. Mow Sun Wong*, 426 U.S. 88, 100 (1976).
[12]. *Butz v. Glover Livestock*, 411 U.S. 182, 187 (1973).
[13]. *E.g., Monieson v. Commodity Futures Trading Com'n*, 996 F.2d 852 (7th Cir. 1993).
[14]. *Blinder, Robinson & Co., Inc. v. S.E.C.*, 837 F.2d 1099, 1113 (D.C. Cir. 1988).

Additional Sources

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2. Wood, S.N. (2011). Fast stable restricted maximum likelihood and marginal likelihood estimation of semiparametric generalized linear models. *Journal of the Royal Statistical Society* (B) 73(1):3-36.

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