CCIR

Canadian
Council of
Insurance
Regulators

Conseil
canadien
des responsables
de la
réglementation
d'assurance

AN APPROACH TO RISK-BASED MARKET CONDUCT REGULATION

A report prepared by the
Canadian Council of Insurance Regulators (CCIR)
Risk-Based Market Conduct Regulation Committee

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Background

Who We Are

The Canadian Council of Insurance Regulators (CCIR) is an inter-jurisdictional association of provincial, territorial and federal insurance regulators. The provincial and territorial regulators are responsible for market conduct regulation and legislative compliance of insurers authorized in their province or territory. Several also have responsibility for the prudential (solvency) regulation of insurers incorporated in their jurisdictions.

History of Risk-based market conduct regulation (RbMCR) project

Interest in applying risk-based methodologies to market conduct regulation has been growing in Canada since the Office of the Superintendent of Financial Institutions' (OSFI) risk-based supervisory framework for prudential regulation was published in 1999 and since several international regulatory organizations began around the same time to take some steps forward in this regard. In 2003, the Insurance Bureau of Canada (IBC) approached CCIR with a proposal called "Implementing Change: A Framework for Market Conduct Supervision," that also suggested that the recent changes to solvency regulation – adopting risk based supervisory techniques and requiring much higher standards of corporate governance – should also be applied to market conduct regulation.

In early 2004, CCIR established the Risk-based Market Conduct Regulation (RbMCR) Committee to explore frameworks for applying risk-based market conduct concepts to the ongoing work of regulators in Canada.

As a first step, the Committee undertook an overview of the goals of risk-based regulation and provided a survey of approaches to it from a variety of international regulators. In July 2004, CCIR published the results in a paper entitled "A Survey of Approaches" (available on the CCIR website www.ccir-ccrra.org).

Since then, both the RbMCR Committee and CCIR as a whole have spent time analysing the results of the Survey and discussing which pieces of the many possible approaches fit our Canadian system and which did not.

In undertaking this work CCIR determined that applying risk-based methodologies to market conduct regulation provides some challenges not present in prudential regulation:

> First, whereas prudential regulators deal solely with insurers, risk based market conduct regulation may also have to encompass different product distribution channels and potentially thousands of intermediaries who are the face of the insurance industry to many consumers
>
> Second, there are a fairly small number of well-defined risks in solvency regulation. Market conduct risks tend to be much more difficult to define and quantify.
>
> Third, market conduct regulators may be charged with looking after a number of functions that do not fit well within a risk-based model. For instance, significant aspects of the regulatory structure around automobile insurance provisions and rate reviews do not lend themselves to a risk-based regulatory approach.

Nevertheless, we are now proposing an approach which could form the basis for a framework for applying risk-based market conduct concepts to the ongoing work of regulators in Canada which is presented in this paper.

Implementation notes

This document reflects the ideas of the regulators who are members of CCIR. It does not necessarily represent the views of any government.

The decision to adopt risk-based methods for assessing market conduct is up to each provincial or territorial regulator individually.

As well, within any jurisdiction, the adoption of risk-based methods for assessing market conduct is not an all-or-nothing proposition. There will be circumstances where risk-based approaches work best and situations where more traditional methods are a better fit. It will be up to individual regulators to decide what methods work best in a given situation.

Because automobile insurance regulation is not within the purview of several CCIR members, collaborative risk-based approaches may be of limited usefulness for this line of business. However, some aspects of automobile insurance regulation may be approached in this fashion.

An Approach to Risk-based Market Conduct Regulation

Defining Market Conduct Regulation

"**Market conduct**" encompasses any product or service relationship between the insurance industry, insurers, agents and individuals alike, and the public. It is influenced by many factors including: laws, established best practices, codes of conduct, and consumer expectations.

To protect the public from unfair market practices, CCIR members oversee a wide range of company and intermediary practices (e.g. sales, underwriting, and claims processing) through a variety of regulatory activities such as licensing, consumer complaint reviews, and on-site examinations. Taken together, these regulatory practices are referred to as **market conduct regulation**.

Defining Risk-based Market Conduct Regulation

Risk-based Market Conduct Regulation means directing regulatory efforts to the most significant issues that either have the greatest potential for consumer harm or that could weaken public confidence if left unchecked. In a risk-based approach, regulators prioritize issues based on their potential impact (risk) to the achievement of desired regulatory outcomes.

Our overall vision for RbMCR includes regulators working with each other and the industry to identify, prevent, and solve marketplace problems or harms and to work toward positive marketplace outcomes.

Most regulatory agencies that have adopted risk-based techniques have done so because they judge that risk-based methods are the best way to meet their mandate to supervise financial markets in the way that best accomplishes the goals of legislation and regulation and ensures confidence in the financial services sector.

For example: Legislation may indicate that insurers must honour legitimate claims within a certain period of time after completed claims forms are filed. A risk-based approach could be used to focus regulatory attention on insurers where indicators suggest there is a high risk of non-compliance with the legislation rather than giving every insurer equal weight and examining them all.

Marketplace Outcomes that Market Conduct Regulation seeks to achieve

By setting up regulatory regimes, governments have attempted to achieve certain public policy goals. Moving toward a risk-based market conduct approach will require that both the regulators and stakeholders have a common understanding of what these desired outcomes of regulation are.

In its work to date CCIR has considered numerous mission statements and goal documents from around the world and we believe that the following marketplace outcomes (or public policy goals) describe the goals of market conduct regulation in Canada.

These desired marketplace outcomes include both **micro-level outcomes** that are within the control of individual firms or intermediaries and broader **systemic level outcomes** that can only be achieved though the collective actions of the entire industry. It is expected that the micro-level outcomes must be achieved before the systemic outcomes can be fully realized.

Micro-level outcomes:

- **Fair treatment of consumers and claimants**

  Ethical and honest behaviour should be the accepted norm among market participants.

- **Disclosure of information to enable consumers to make informed decisions**

  In keeping with fair treatment, consumers should have access to simple, easy to understand information.

- **Compliance with laws**

  Market participants must comply with statutory, legal and corporate obligations.

- **Good corporate governance**

  Companies should identify and manage risks through internal controls, risk management and business oversight mechanisms.

Systemic level outcomes:

- **Stable marketplace**

  In which the needs of consumers for understandable, available, accessible and affordable insurance are met;

- **Proactive identification of issues**

  Collaboration between industry and regulators to prevent issues from arising rather than merely fixing problems after they happen; and

- **Fair Dispute Resolution**

  A process by which disputes are dealt with by participants in a fair, timely and responsive manner.

What are the Potential Benefits of a Risk-based Approach?

It is clear from discussions among regulators, both domestically and internationally, that risk-based regulation, increased standards for corporate governance and outcome oriented regulatory standards are closely inter-related. Taken together, their adoption by regulators appears to greatly enhance the efficiency and effectiveness of the regulatory paradigm. There are potential benefits for all parties – consumers, intermediaries, insurers, regulators, and governments - in a risk-based approach to market conduct regulation. These include:

- **Clarity and transparency of regulation**

  Because the identification and prioritization of risk requires an ongoing dialogue between regulators, consumers and industry, a risk-based approach would contribute to the clarity and transparency of the regulatory process.

- **Better understanding of risks**

  This continuing dialog will also assist market participants, over time, to a better understanding of actions that constitute risks to the achievement of the marketplace outcomes regulators are trying to achieve.

- **Alignment with corporate governance**

  As this dialogue is centred on risks to marketplace outcomes, it is better aligned with enterprise risk management within the insurance industry. This alignment underscores the importance of corporate governance in modern regulation. If members of the industry understand the marketplace outcomes regulators are trying to achieve and how regulators assess risk to those outcomes, they can more readily assess the risk implications of their actions and see the areas where their internal policies and procedures need to be improved to keep risks in check.

- **Proactive approach to preventing or solving problems**

  Sound knowledge of the risks which may impede desired marketplace outcomes increases the probability that solutions can be found before potential risks become major problems. Problems with the potential for a big impact on individual consumers or that affect a large number of market participants would be addressed by regulators first. In this way, risk-based approaches to market conduct regulation provide a method for proactively zeroing-in on issues that have the greatest relevance.

- **Systemic focus on market place and consumers**

  Traditional methods of enforcing market conduct are, by their nature, reactive; designed to catch and punish. As such, they sometimes have a limited impact on overall conduct in the marketplace. A risk-based approach focuses regulatory efforts on market place outcomes, thus providing a systematic focus that has sometimes been missing in traditional market conduct regulation.

- **Increased regulatory efficiency**

  A regulator's key role is to enforce laws put in place to protect consumers. Risk-based approaches provide a more efficient way of doing that by dealing with problems that may affect many consumers at one time, rather than dealing with them solely on a case by case basis. As well, the risk-based approach recognizes that regulatory resources, both human and financial, are limited and choices must be made. In a risk-based regime, these choices are based on identified risks to marketplace outcomes, allowing regulators to have a greater impact with their limited resources.

- **Reduced regulatory costs for well managed market participants**
  It is anticipated that market participants that manage their market conduct risks well will benefit by receiving less intensive regulatory scrutiny or intervention than higher risk participants.

Regulatory Principles for Risk-based Market Conduct Regulation

Regulators have considered a variety of principles for risk-based regulation. Thus far, there is agreement that the following regulatory principles should form the basis of our risk-based market conduct regulatory approach. These are principles for regulators to follow, though each of them also implies complimentary principles for industry participants.

1. **Developing Understanding**

   To move from enforcing rules to assessing degrees of achievement of marketplace outcomes will require regulators to have a fulsome understanding of the market and its participants.

   Regulatory understanding falls into three categories:

   a. <u>The external environment:</u> includes an understanding of economic and business conditions. This can be achieved through scanning the media and independent market analysis, including those prepared by other government agencies, about information that may influence the conduct of market participants;

   b. <u>Consumer and system-wide risks</u>: these may be broad issues (e.g. e-commerce) which require very careful definition of the issues involved, or they may be focussed on a particular product or a vulnerable consumer group (e.g. seniors). In any case, the regulator may seek information through an informal survey or visits with company managements to gain a better understanding of the matter;

   c. <u>Market participants:</u> information from individual complaints may identify potential problems before they become more serious or systemic.

2. **Reliance on Governance and Controls**

   Regulators should emphasize governance as the focus of their risk analysis and assessments of companies and intermediaries. It is the responsibility of boards and senior management to adopt governance practices, policies, procedures and systems that will lead to successful market conduct outcomes. Regulators will expect and rely on good corporate governance as a means of ensuring that individual firms and intermediaries are in compliance with marketplace standards.

3. **Exercising Judgement**

   Regulators should use their understanding and exercise sound judgement when assessing risk and deciding where to spend their finite resources. Regulators will address the most important things first.

4. **Risk Assessment and Management**

Regulators' actions should be commensurate with risk. Where possible, regulators will set levels of tolerance for various market risks that are appropriate for their jurisdictions. Regulators will respond to risks in a measured way, focusing on the most significant risk first and keeping in mind the regulatory objectives. Regulators will give due consideration to market conditions, risk profiles (participant's size, nature and complexity), key issues, any mitigating action taken by the participant, and past supervisory findings.

5. **Selective use of Tools**

Regulators should develop and use a broader range of tools and apply the ones that are best suited to achieving a particular desired regulatory outcome. The categories of tools will include:

a. **Diagnostic**: designed to identify, assess and measure risks (e.g., desk based reviews and analysis of information or reliance on external auditors);
b. **Monitoring**: to track the development of identified risks, wherever they arise (e.g., supervisory team visits or requests for additional information);
c. **Preventative**: to mitigate identified risks and prevent them from becoming more serious (e.g., letters to CEO/Board or imposition of conditions or directions);
d. **Remedial**: to respond to risks when they have emerged (e.g., exercising powers of intervention or revocation of authorizations);
e. **Enforcement**: to rectify unacceptable or unmitigated risks (e.g., revocation of authorizations or prosecution).

Some of these regulatory tools – for instance remedial and enforcement tools - are brought forward from traditional regulation, though their use would now be driven by risk assessments and the other regulatory principles. Others – like some diagnostic and monitoring tools – are relatively new and would require development.

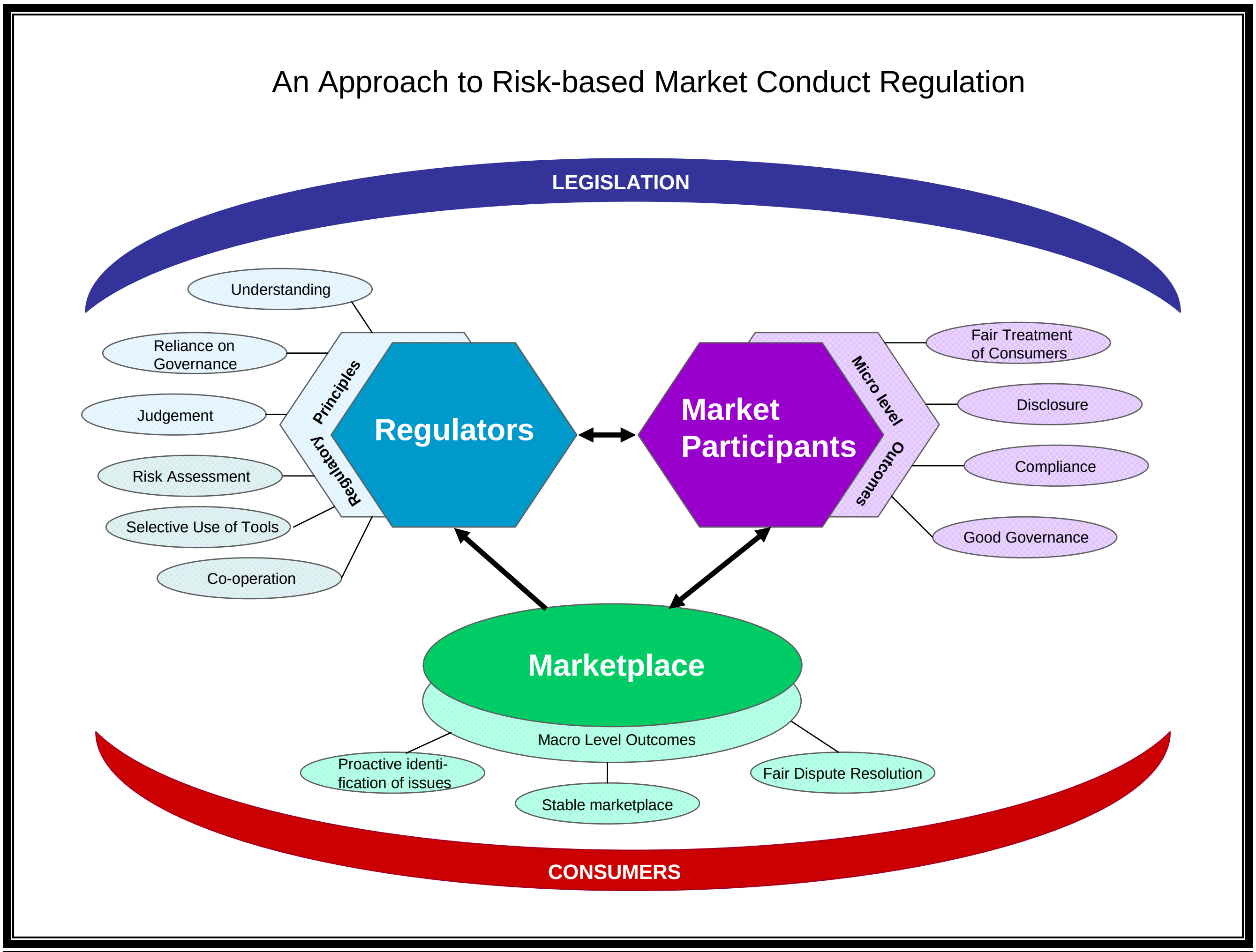
Regulators have gained some experience with risk-based market conduct tools such as self-assessment questionnaires and complaint reporting systems. Going forward, we will continue to use these established tools, develop additional tools to support the other regulatory principles and look for additional opportunities in which to apply risk-based market conduct techniques.

6. Co-operation

Regulators should find ways to improve co-operation and information sharing with each other and industry. Many market participants operate in more than one Canadian jurisdiction and there is a need for regulators to co-operate to enhance regulatory understanding and avoid unnecessary duplication and delays.

Regulators also need to work co-operatively with market stakeholders and participants to keep in touch with market changes and encourage development and adoption of industry codes of conduct and other market guidance.

Below is a graphic representation of our vision of how these various aspects fit together into an ongoing system.



The Road Ahead

We look forward to your input on the approach to risk based market conduct regulation.

The outcomes and principles of risk-based market conduct regulation will be finalized at the end of this consultation and implementation will begin.

Implementing RbMCR will require the following key components to move forward at the same time. Regulators will:

- **Adopt and apply the RbMCR principles in our everyday work**
  Regulators, individually and collectively, will increasingly apply the principles and approaches outlined in this paper to their market conduct activities.

  While application of the principles will begin immediately, it should be noted that changes will be incremental in most jurisdictions: they will take time and will not appear in all places or on all topics at the same time. Advances will occur as we gain experience in determining where risk-based methods and tools can be most effectively applied to achieve the outcomes of risk-based market conduct regulation outlined in this paper.

- **Work With Insurance Councils to ensure they apply the RbMCR principles**
  Regulators in jurisdictions with Insurance Councils will bring the RbMCR principles to the attention of the Councils and encourage them to apply the principles to their work.

- **Support Industry Association Efforts Promoting Adoption of Best Practices**
  Regulators will support the continuing development and implementation of sound governance practices, standards and guidelines throughout the industry which, in turn, will give rise to high standards of market conduct performance and compliance.

  We acknowledge the significant progress the industry has recently made in the establishment of standards and guidelines and look forward to further progress in this critical component of a risk based approach to market conduct regulation.

- **Support Industry Ombudservices**
  The existence of a fair and effective consumer dispute resolution system will allow regulators to concentrate their resources on dealing with problems with the potential to negatively affect consumer confidence in the Canadian insurance system, knowing that other consumer issues are being dealt with objectively by the OmbudServices.

- **Identify legislative barriers**
  In the course of developing and implementing risk-based processes, it is possible that regulators or industry may identify legislative requirements that are not amenable to risk based market conduct regulation. As such issues arise, regulators will bring them to the attention of legislators.