

Adrian M. Fenty  
Mayor

Thomas E. Hampton  
Commissioner



# Market Conduct Examination



Government of the District of Columbia  
Department of Insurance, Securities, and Banking

(NAIC ACCREDITED)

**Government of the District of Columbia**  
**Department of Insurance, Securities and Banking**



Thomas E. Hampton  
Commissioner

March 9, 2008

I, Thomas E. Hampton, Commissioner of Insurance, Securities and Banking of the District of Columbia, hereby certify that I have compared the annexed copy of the

**LIMITED SCOPE MARKET CONDUCT EXAMINATION REPORT**

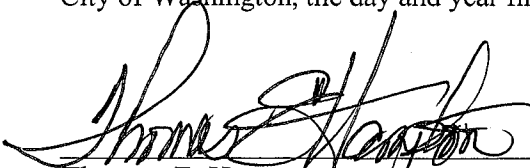
**FOR THE**

**THE SURETY & FIDELITY ASSOCIATION OF AMERICA**

**AS OF DECEMBER 31, 2005**

With the original on file in this Department and the same is a correct transcript there from, and of the whole of said original.

IN WITNESS WHEREOF, I have hereunto set my  
hand and affixed the seal of this Department, at the  
City of Washington, the day and year first written



Thomas E. Hampton  
Commissioner of Insurance, Securities and Banking

Market Conduct Examination Draft Report of  
THE SURETY & FIDELITY ASSOCIATION OF AMERICA  
For the Period  
January 1, 2000 through December 31, 2005

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## **SALUTATION**

March 9, 2008

Honorable Thomas E. Hampton  
Commissioner, District of Columbia  
Department of Insurance and Securities Regulation  
810 First Street, NE, Suite 701  
Washington, DC 20002

Under the provisions of the District of Columbia Official Code, Title 31, Section 1401 et seq., and §31-2708(a)(1), a limited scope examination was made of the conduct, performance, and practices of

The Surety & Fidelity Association of America

with administrative offices located at 1101 Connecticut Avenue, NW Suite 800, Washington, DC 20036. This market conduct examination, as of December 31, 2005, reflects the business activities for The Surety & Fidelity Association of America, hereinafter referred to as the "Association".

## **FORWARD**

The advisory organization examination is a review of the Association's systems, operations and management for the collection and reporting of statistical data, preparation of loss cost filings and rule and form filings. Its purpose is to verify that adequate statistical plans are maintained in accordance with DC Official Code §§31-2707 and 31-2708, check the validity of the systems in place, the internal procedures for preparing rate/loss costs reviews and submissions to insurance departments and companies, including the timeliness and quality of the response. The advisory organization examination is not an examination of the accuracy of the underlying company data reported to the Association. The main purpose of the examination is to look at what the advisory organization does with the data it collects, compiles and reports so that the Department of Insurance,

Securities, and Banking (DISB) knows that the statistical, loss cost, rule and form filings made with them are reliable.

The Association serves its members as a statistical agent, who collects and reports loss experience, a rating bureau, which develops aggregate loss costs for us by member companies, and a trade organization. In the Associations' mission statement strategies, it identifies the following objectives for its member companies:

1. Establishing positions and policies on fidelity and surety issues;
2. Taking a leadership role in cooperation with related trade associations in directing and coordinating industry legislative and regulatory activities;
3. Acting as a statistical agent and providing assistance to its members in the development of rules, procedures, risk classifications and loss costs for fidelity and surety bonds;
4. Acting as a clearinghouse of information, educating, informing and providing services to its members and the general public to promote the value and use of fidelity and surety bonds.

The loss cost development process is designed to gather industry-wide data and aggregate and disseminate loss information and expenses. The statistical component of the loss cost development process is to assure the public of fairness for rates ultimately developed and charged by members of the Association that opt to use the Association's loss costs when submitting filings with insurance departments. There is a point of view that collecting and sharing pure data in a coordinated fashion among member companies and also serving its member companies as its national trade representative could be a conflict of interests due to the objective nature demanded in ratemaking. However, since the Association has not established rates for over a dozen years, this concern is mitigated. After examination of both functions of the Association, the DISB found no evidence of any such conflict of interest

The examination report notes those areas or items with which the DISB takes exception. A violation is any instance of the Association's activity that does not comply with a statute or regulation. The Association's policies, practices and procedures are only

commented on for the purposes of giving the reader clarity. The examination report may include management comments addressing observations and recommendations noted by DISB but for which no statutory violation exists.

The onsite phase of the examination was conducted at 1101 Connecticut Avenue, NW Suite 800, Washington, DC 20036. In reviewing material for this report, the examiners relied primarily on records and materials furnished by the Association. A significant volume of material was provided prior to the onsite examination, as well as during the onsite examination. All materials were provided both in paper and electronic format.

### **SCOPE OF EXAMINATION**

This examination covers the period January 1, 2000 through December 31, 2005. Subsequent events are noted and included in all sections of the report up to the last day of fieldwork. The examination fieldwork commenced on September 25, 2006 and concluded on January 30, 2007, and included over 1,200 hours of review. The examination is comprised of two components. The first component is to determine compliance by the Association with provisions of the law and obtain facts relative to its business methods relating to verifying statistical plans, data collection and handling and data calculation accuracy. The second component is the review of internal procedures in preparing loss costs reviews and submissions to insurance departments and companies, including the timeliness and quality of responses.

During the first component of this examination, the Association's statistical operations were reviewed as identified in the 2006 NAIC Examiners Handbook, Volume I, Chapter XVI and Volume II, Chapter XXV. The standards set forth in these chapters are based on established procedures and /or NAIC models, not on the laws and regulations of the District of Columbia. Below is a list of the business areas where NAIC standards were applied. Across from each business area are the test standards that can be referenced in the 2006 NAIC Examiners Handbook. Any failed standard is commented on in the body of this report.

BUSINESS AREAS

REVIEWED

- (A) Operations;
- (B) Statistical Plans;
- (C) Data Collection and Handling;
- (D) Communications with Companies and Regulators;
- (E) Reports, Report Systems and Other Data Requests

NAIC STANDARDS

APPLIED

- A-1, A-2, A-3, A-4, A-5,  
A-6, A-7, A-8, A-9
- B-1, B-2
- C-1, C-2, C-3, C-4, C-5
- D-1, D-2, D-3, D-4
- E-1, E-5

For the second component of this examination, the loss costs review portion, the examiner's focused on the following items:

- 1) The Association submits loss cost submission to a state within the established time frame;
- 2) All calculations used to develop the loss costs have been performed accurately;
- 3) The Association has accurately extracted the appropriate information from the statistical database;
- 4) Loss costs reviews were adequately reviewed for quality, correctly compiled and uses appropriate ratemaking procedures; and
- 5) Documentation concerning loss costs was adequately communicated to member companies.

The examiners were provided work papers by the Association's current independent auditor, Stokes & Company, for review. Certain procedures and conclusions documented in those work papers have been relied upon and copied for inclusion into the work papers of this examination.

The Association's function as a trade organization is not included in the scope of this examination.

One primary function of the Association is to create and file statistical plans that con-

form to insurance regulation standards. The Association has published two statistical plan manuals and is solely responsible for the development and modification of these plans. Member companies and groups and non-member statistical filers submit the statistical information required by plans directly to Insurance Services Office, Inc. (ISO) for processing. ISO's processing is not included in the scope of this examination.

Failure to identify or criticize specific practices does not constitute acceptance of such practices by DISB.

## **ASSOCIATION PROFILE**

### **History and Operations**

The Association is a voluntary, non-profit, incorporated association of companies engaged in the business of suretyship. It was organized in 1908 to encourage the development of forms and coverages with respect to fidelity, surety and guarantee bonds and forgery insurance and to provide a forum for the discussion of problems of common interest to its members as is more fully set forth in the bylaws.

On October 23, 1947, the Surety Association of America absorbed the personnel and rating functions of the Towner Rating Bureau, Inc. under an amended constitution that authorized the Association to operate as a rating and or advisory organization throughout the United States of America, its territories and possessions. All licenses issued to the Towner Rating Bureau either were transferred to or reissued in the name of The Surety Association of America.

The constitution was amended on June 6, 1996, to make the committee structure more flexible, to more clearly define eligibility to serve on the Board of Directors and to make gender and editorial changes to the document.

On May 3, 2002, the Association's Board of Directors voted to adopt a corporate form of organization. As a result, the Association formed a non-profit District of Columbia



corporation. The Surety Association of America drafted bylaws to replace the constitution of the unincorporated Association. At the annual meeting on May 12, 2005, the members voted in favor of an amendment to the bylaws to allow companies to withdraw only by giving notice of at least 90 days before the beginning of the Association's fiscal year.

On May 18, 2006, general membership of the Association voted to change the name of the Association from The Surety Association of America to The Surety & Fidelity Association of America. The bylaws were amended to reflect the new name following the affirmative vote. The District of Columbia DISB approved the name change and issued a revised Certificate on May 26, 2006.

### **Officers and Directors**

The officers of the Association as of December 31, 2005, were:

Ms. Lynn M. Schubert, President  
Mr. Edward G. Gallagher, General Counsel  
Ms. Lenore Marema, VP of Government Affairs

The Directors of the Association as of December 31, 2005, were:

Mr. Stephen M. Haney	Mr. Richard Van Steenburgh
Mr. Vincent Forte	Ms. Tracey Vispoli
Mr. John F. Welch	Mr. James McMahan
Mr. Gary T. Dunbar (Chair)	Mr. David T. Akers
Mr. John Hannum	Mr. Denis Perler
Mr. Steve Anderson	Mr. Lloyd E. Geary
Mr. James E. Lee	Mr. Michael Peters (Vice Chair)
Mr. Thomas M. Kunkel	Mr. Richard L. Kinnaird
Mr. Richard F. Yeazel	

The authority of each officer is spelled out in the bylaws and further defined by employment contracts and/or job descriptions. The president, Lynn M. Schubert, has the overall executive responsibility for the management of the Association and is directly responsible for carrying out the orders of the Board.

The board of directors is the overall governance body for the Association. Board members, like officers, have a fiduciary duty to act in the best interests of the Association and cannot put their own interests ahead of the Association.

## **METHODOLOGY**

The examination process consists of a sequence of activities. Obtaining and confirming an understanding of the company's operational system is vital in the examination process and is performed through transaction reviews and interviews. This examination process is performed whether a traditional market conduct examination approach or a risk-focused examination approach is selected.

DISB selected to use a risk-focused approach, which places emphasis on a firm's risk management culture, corporate governance structure, risk assessment programs and control environment. The process includes interviews with key members of management, verification of additional internal control documentation if available, and an increased level of importance in coordination with external and internal auditors. This approach brings focus to the broader issue of management's ability to identify, assess and manage the business risks it encounters.

After the examiners obtain operational knowledge, an evaluation or risk assessment is performed of the company's unique characteristics, identifying and summarizing the major risks that then drive the individual exam area strategies.

Although the sequence of activities outlined above occurs in every DISB market conduct exam, a significant portion of the examination is based on 2006 NAIC Handbook standards for documents reviewed. Standards were evaluated based on general data gathered by the examiner or provided by the company in response to inquiries. No testing of gathered data was performed.

The risk-focused approach calls for greater reliance upon and testing of controls that mitigate or reduce risk; however, the examiner's judgment determines the specific procedure to be applied to each exam area.

An NAIC Handbook standard is not materially malfunctioning when the examiner substantiates that the controls surrounding the process of generating the results for that standard are designed properly and are operating effectively. None of the NAIC standards were measured using tests designed to adequately measure how well the company met the standard. Each standard applied is listed under the caption, "Scope of Examination". Any failed standard is described in the body of the report under its respective area of review. The loss costs review area appears in the report following the NAIC Handbook standards and details the item reviewed along with a conclusion statement.

Areas of review show the NAIC standard inside borders followed by a "Comments" section, followed by examiner "Findings", and by "Observations and Recommendations" sections. The Association's response (if any) to either findings or observations then may follow. The "Findings" section may contain violations or where NAIC standards were determined deficient. Findings that are in violation of a D.C. Official Code Section are found at the end of the report under the caption, "Summary of Violations".

## **NAIC STANDARDS REVIEWED BY BUSINESS AREA**

### **Operations**

The evaluation of standards in this business area is based on a review of the Association's responses to the information requested, questions asked, staff interviews and general representations made to the examiners.

<p>NAIC Standard A-1 The Association has an up-to-date, valid internal or external audit program.</p>
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Comments: The review methodology for this standard does not have a direct statutory requirement. A company that has no internal audit function lacks the ready means to detect problems until after problems occur.

Findings: The Association engages an external audit firm but there is no formal internal review process documented.

Observations and Recommendations: None

Response: The Association President reviews quarterly financial statements and accounts receivables.

NAIC Standard A-2

The Association has appropriate controls, safeguards and procedures for protecting the integrity of computer information.

Comments: The review methodology for this standard does not have a direct statutory requirement. A company's failure to provide appropriate control procedures for protecting data stored on its information system could cause harm to members. Policies, standards, guidelines, and procedures are the blueprints for the examiners to determine if the company has a successful information security program.

Findings: The Association has a written policy of protection of the integrity of computer information which it follows. The safeguards include password protection for members' only information. Company usernames and passwords are assigned by the Director of IT only, and provided to the Chief Bonding Officer or each member company. In order to provide a company username and password, the request must be verified as originating from the member.

Observations and Recommendations: None

NAIC Standard A-3

The regulated entity has antifraud initiatives in place that are reasonably calculated to detect, prosecute and prevent fraudulent insurance acts.

Comments: The review methodology for this standard does not have a direct statutory requirement. The standard is primarily focused on internal fraud and whether the company has a process for detection and prevention. Failure to provide an appropriate process may cause harm to members through financially impacting the Association.

Findings: Nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard A-4 The company has a valid disaster recovery plan.
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Comments: The review methodology for this standard does not have a direct statutory requirement. Disaster recovery planning is concerned with the resources, processes, and equipment needed to restore business facilities when a disaster has struck. Recovery plans involve employee teams that spring into action to keep the critical function performing and working to restore the original facilities to return to business as usual.

Findings: There is no formal plan that addresses the typical areas included in a disaster recovery plan.

Observations and Recommendations: It is recommended the Association develop a more comprehensive formal Disaster Recovery Procedure that includes the Association's process in the event of a disaster, the recovery process and controls to ensure the procedure is affectively working and a process to ensure all employees adhere to the procedure.

Response: The Association has a formal IT Disaster Recovery Plan which was provided to the consultants and is followed. All statistical data submitted pursuant to the SFAA Statistical Plans is housed both at the SFAA and at Insurance Services Organization (ISO). ISO has a detailed Disaster Recovery Plan which is followed.

NAIC Standard A-5 Contracts between the regulated entity and entities assuming a business function or acting on behalf of the regulated entity, such as, but not limited to, managing general agents (MGAs), general agents (GAs), third-party administrators (TPAs) and management agreements, must comply with applicable licensing requirements, statutes, rules and regulations.
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Comments: This standard is focused on the degree of control the Association factors into its outsourcing contracts and the compliance process structure used to assure adherence to contract terms.

Findings: Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard A-6
The regulated entity is adequately monitoring the activities of any entity that contractually assumes a business function or is acting on behalf of the regulated entity.

Comments: This standard is focused on the level of oversight provided by the Association when it delegates functional areas of work or tasks outside of its operational structure.

Findings: The Association is in frequent contact with ISO regarding the statistical data collection process, and reconciles Annual Statement data obtained from the Annual Statements with statistical plan data collected by ISO and reported to the Association through Reconciliation Statements. Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard A-7
Records are adequate, accessible, consistent and orderly and comply with state record retention requirements.

Comments: The review methodology for this standard does not have a direct statutory requirement. This standard is intended to assure that an adequate and accessible record exists of the company's affairs and transactions.

Findings: Through the review of a significant volume of records, nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

Response: The Association keeps almost 100 years of records either on-site or at an off-site facility, some in hard copy and some in microfiche. The Association also has implemented an electronic document filing system utilizing Worldox for all documents and is in the process of converting all paper files to electronic format. DISB was provided with all documents requested during the examination in both hard copy and electronic format.

NAIC Standard A-8

The Association is properly licensed for the business it transacts.

Comments: The DC Official Code §31-2706(c)(1) that required the Association obtain a license from the Commissioner as repealed in 2002. The DC license held by the Association is perpetual without the payment of any continuing licensing fees to keep it in force.

Findings: The Association's license is in compliance with this standard.

Observations and Recommendations: None

NAIC Standard A-9

The Association cooperates in a timely basis with examiners performing the examination.

Comments: The review methodology for this standard does not have a direct statutory requirement, however the standard is inferred by D.C. Official Code § 31-1403(b) that states in part every company or person from whom information is sought must provide free access to all documents and affairs under examination at all reasonable hours at its offices. This standard is intended to assure that the company is cooperating with the regulatory jurisdiction in the completion of an open and cogent review of the company's operations in the District.

Findings: The Association is in compliance with this standard.

Observations and Recommendations: None

Response: The Association cooperated fully with all requests of the examiners. Significant information was provided prior to the on-site review. While on-site the examiners were provided with all requested documents, both in hard copy and electronic format, and the examiners were provided a username and password to access relevant sections of The Association website to facilitate their review. This included not only all statistical and actuarial data, but all committee and Board of Directors reports, agenda and minutes, corporate governance documents, outside audits, etc. All requested staff were made available for interviews whenever requested, whether or not The Association felt they were relevant to the examination. All requested staff answered all questions fully and provided all information requested freely. Hundreds of staff hours were spent cooperating with and assisting the examiners. Staff also arranged for and participated in conference calls with the examiners and ISO staff whenever requested.

Statistical Plans

NAIC Standard B-1

The statistical agent has filed its statistical plans in accordance with applicable statutes, rules and regulations.

Comments: The review methodology for this standard has a direct statutory requirement in DC Official Code §31-2707(b).

Findings: The Association is in compliance with this standard.

Observations and Recommendations: None

NAIC Standard B-2

The statistical plans are reviewed and updated in accordance with applicable statutes, rules and regulations.



Comments: The review methodology for this standard has a direct statutory requirement in DC Official Code §31-2707(b).

Findings: Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

Response: The statistical plans are reviewed periodically based on changes in the industry, upon request of member companies, and generally, to ensure that they continue to provide the best information available for regulators, members and statistical filers.

### **Data Collection and Handling**

#### NAIC Standard C-1

The statistical agent's series of edits are sufficient to catch material errors in data submitted by a company.

Comments: The review methodology for this standard does not have a direct statutory requirement.

Findings: After reviewing the statistical plans and the edit process, nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

#### NAIC Standard C-2

All data that is collected is run through the editing process.

Comments: The review methodology for this standard does not have a direct statutory requirement.

Findings: Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

Response: All data collected is run through the edit process each year when submitted. Both ISO and SFAA staff follow up with companies that need to submit corrected data to ensure that correct data ultimately is filed by all members and statistical filers.

NAIC Standard C-3

Determine that all databases are updated as needed with all accepted company data.

Comments:

Findings: Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard C-4

Determine that statistical data is reconciled to the State Page Exhibit of Premiums and Losses, Statutory Page 14, of the NAIC annual statement on an annual basis.

Comments: The review methodology for this standard does not have a direct statutory requirement.

Findings: The Association in compliance with this standard.

Observations and Recommendations: None

NAIC Standard C-5

Determine that all calculations associated with the database have been accurately applied.

Comments: The review methodology for this standard does not have a direct statutory requirement.

Findings: Nothing came to the attention of the examiner to note the Association was not in compliance with this standard.

Observations and Recommendations: None

### **Communication with Companies and Regulators**

NAIC Standard D-1

The statistical agent keeps track of companies that fail to meet deadlines.

Comments: Statistical agents employ Incentive Assessment Plans. The examination reviews the statistical agent's records to note the timeliness of the statistical agent's notification to the companies of data errors or questions, as well as any necessary follow-up communications.

Findings: After review of the application of the Incentive Assessment Plan during the period covered by the examination, nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard D-2

The statistical agent has established procedures for notifying companies (and regulators, as requested or required) of errors and for correcting errors.

Comments: The purpose of this section of the exam is to verify that the statistical agent promptly notifies the company when a problem with or question about the data is found, and then follows up, if the company does not respond within the appropriate time frame.

Findings: Nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard D-3

The statistical agent maintains a follow-up procedure with companies that have reporting errors or questions.

Comments: The examination reviews the statistical agent's records to note the timeliness of the statistical agent's notification to the companies of data errors or questions, as well as any necessary follow-up communications.

Findings: Nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard D-4

Review any additional data quality programs maintained by the statistical agent.

Comments: The review methodology for this standard is based on the review of communications, including but not limited to, the various aspects of the statistical agent's contact and/or correspondence with companies and regulators.

Findings: Nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

**Reports, Report Systems and Other Data Requests**

NAIC Standard E-1

The statistical agent reports data to a state within the established time frame.

Comments: The review methodology for this standard does not have a direct statutory requirement so the review is based on the Association's custom and practice.

Findings: Nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

NAIC Standard E-5

All data collected, in addition to the data collected under the statistical plan, was adequately reviewed for quality and compiled according to applicable statutes, rules and regulations.

Comments: The review methodology for this standard does not have a direct statutory requirement. The purpose of this portion of the exam is to review the statistical agent's reports and other statistical compilations prepared for the states, as well as the statistical agent's internal procedures for preparing reports and responding to data requests, including the timeliness and quality of the response.

Findings: After review of all reports and compilations prepared for the states during the period of the examination and the Association's internal procedures, nothing came to the attention of the examiner to note the Company was not in compliance with this standard.

Observations and Recommendations: None

### **RATE/LOSS COSTS REVIEW**

The purpose of this portion of the exam is to review the Association's internal procedures for preparing rate/loss costs reviews and submissions to insurance departments and companies, including the timeliness and quality of the response.

The loss costs review included procedures that developed a conclusion for each of the items identified below.

Item 1

The rating or advisory organization submits rates/loss cost submission to a state within the established time frame.

Conclusions:

There is no formal internal “review” (“review” means that the indicated loss cost level change for a given line for the latest experience period is produced internally and based upon that indication, a decision is made by staff whether to make a filing) or filing schedule which is followed by SFAA. It is recommended that a “review” of loss costs should be annually conducted internally and that the data and actuarial supporting exhibits underlying that review should be distributed to the membership in the event that a filing is not made, so that the companies can make their own decisions concerning their deviations from the last approved loss costs, based upon this later data.

Response: All statistical data, including data specifically by class code, is made available to member companies and subscribers in reports each year. In addition, The Association conducts and publishes a Contract Bonds Loss Severity Study periodically to supplement the statistical data. While The Association previously did not have a formal loss costs review schedule, we have implemented a schedule for surety and fidelity to be reviewed (as defined above) in alternate years.

Item 2

All calculations used to develop the rates/loss costs have been performed accurately.

Conclusions: A great deal of data manipulation and spreadsheet development is undertaken by the actuarial trainee. His work is reviewed by the actuary but this review is more high level to the extent it is looking for the reasonableness of results rather than physically checking the macros and other formulas being utilized.

Recommendations: A more extensive technical review procedure should be investigated in order to ensure that the programs being used are correct.

Response: The Actuary reviews any formulas used. In addition, the Actuarial Advi-

sory Committee reviews the loss costs methodology on a regular basis and suggestions are reviewed and frequently incorporated in the review process. The Actuary will physically check macros in the future.

Item 3

The rating or advisory organization has accurately extracted the appropriate information from the statistical database.

Conclusions: SFAA relies on ISO to collect and consolidate the statistical data. The data is then input into SFAA internal databases which are used for actuarial processes—loss development: trend; on-level/premium at present rates; etc. Other portions of this examination covered the ISO controls which are utilized.

There has not been an effort to validate any data which was compiled prior to the current staff joining the firm.

There is also a question as to whether SFAA or ISO “earned” the exposures which are an input to this calculation. (Written exposures are reported in the statistical plan and must be adjusted to an earned basis by using the effective date and expiration dates adjusted for mid-term adjustments for each policy and annualizing the written exposures). SFAA staff initially responded that the earned exposures were reported by the companies in the statistical plan but that was not the case.

Recommendations: SFAA staff should periodically review specifications with ISO to ensure understanding of the data provided to them by ISO.

Response: The data had been subjected to the validity process discussed earlier in this report. The data was also filed with the District and other states. The data compiled previous to the current staff joining The Association was verified by the staff at the time, filed with the District and other states, and subject to previous Market Conduct Examinations. The Actuary complied with Actuarial Standards of Practice #23, “Data Quality”, Section 3.5 which states, “the actuary should take into account the extent of any checking, verification, or auditing that has already been performed on the data.”

As recommended, staff will periodically review specifications with ISO to ensure understanding of the data provided to them by ISO.

Item 4

Rate/loss costs reviews were adequately reviewed for quality correctly compiled and uses appropriate ratemaking procedures.

Conclusions below each of the following numbered captions:

Ratemaking procedures:

(1) Trend - A detailed retrospective analysis of the underlying components of trend (loss severity, claim frequency and premium trend) should be conducted in order to validate whether the simplistic assumptions that loss severity trend is offset by premium trend and that the use of a 12 year cycle adequately measures claim frequency trends are justified and whether a more rigorous procedure which deals with each of these components explicitly is more appropriate for use. Additionally, there should be an analysis undertaken to determine if the base period which is being used (currently 1999 — 2003) is biased and whether an adjustment should be made to more explicitly project the loss costs to a prospective anticipated level.

Response: While generally accurate, these comments do not discuss the issue from strictly a fidelity and surety basis. Trending issues have been looked into and the conclusion of actuaries experienced in these product lines is that traditional methodology used for other lines are not suitable for surety and fidelity.

(2) Loss development — the methodology which is used is reasonable except prior data has been accepted at face value and there has not been an effort to validate any data which was compiled prior to the current staff joining the firm.

Response: This issue is discussed above.

(3) Credibility - the selected criterion seems reasonable but it does not appear that a rigorous actuarial analysis has been undertaken to validate this procedure although it has



been to the advisory actuarial committee for peer review.

Response: The selected criterion was developed and recommended by members of the SFAA Actuarial Advisory Committee, which is comprised of company actuaries specializing in surety and fidelity. The methodology has been accepted by the District and all states where these loss costs are filed.

(4) Classifications - The classification procedures which are being used by staff are not up-to-date with the more sophisticated predictive modeling procedures (E.G. Generalized Linear Modeling [GLM]) which are being used by most actuaries today.

Also, an analysis of the data by state should be prepared on a regular basis in order to determine if loss costs should vary by select state groupings. To the extent that differences in loss costs exist by state and are not reflected in the filed loss costs, a subsidization of high loss costs' states by low loss costs' states would result. This would be considered to be unfairly discriminatory from a rate regulatory perspective.

In addition, the territory experience which is now being collected should similarly be reviewed when credible data is available in order to assure that the loss costs are not unfairly discriminatory within the states.

Response: The use of such procedures will be discussed with members of the SFAA Actuarial Advisory Committee. However, it is not clear to what extent or whether the specific model cited (GLM) is actually being used by company actuaries for fidelity and surety. We will pursue this.

Data by state is analyzed and state exception pages are filed when requested by state insurance departments. The volume of data in most states by class code is not significant enough to create actuarially sound state specific loss costs. The Association does review territory experience and will use this in each loss costs review. In addition, data grouped by state is provided annually to member companies to assist them in their ratemaking and pricing decisions.

(5) On-level calculations - the currently filed and approved Fidelity loss costs are based on the “on level” method and the later data which is available on the preferable “premium-at-present-rates” basis has not been reviewed in order to test the adequacy of the current loss costs.

Response: The Fidelity loss costs relativities were revised subsequent to the exam period. The adequacy of these loss costs will continue to be tested.

(6) Catastrophe load/Accident Year weights - Consideration should be given to segregate the “cat” losses from the “normal” losses in such a way that more recent data could be used to develop the normal loss costs with a longer period used to measure the “cat” exposure and load this cat provision into the base loss cost. This “cat” loss procedure could make use of data which is available from the financial statements to supplement the data which is available from the new report system such that a full 12 year (or longer) period could be used to develop the cat load. For “normal” losses, a more traditional five year experience period could be utilized and the use of accident year weights which give more credibility to the most recent years (for example 10-10-20-30-30) could be utilized.

Response: This topic has been discussed by the Actuarial Committee. Consideration has been given to the segregation of “cat” losses from “normal” losses, and will continue to be looked at each year. However, as of now, the Actuarial Committee and the Association Actuary do not believe the comments are applicable to fidelity and surety. There is nothing “normal” or “traditional” about these lines. The 10-10-20-30-30 method is an arbitrary assignment of credibility used by ISO and while we will review its applicability and value, we cannot guarantee that the Association will implement this method.

Recommendations: Staff should investigate the benefits of more sophisticated predictive modeling procedures.

Response: This issue will be brought to the Actuarial Committee and reviewed.

Recommendations: Fidelity loss costs should be reviewed utilizing the new methodology in order to determine whether a revision to the loss costs is necessary.

Response: A Fidelity loss costs review is scheduled for 2008

Item 5

Documentation concerning rate/loss cost was adequately communicated to member companies

Conclusions: The supporting documentation in the rate filing and other actuarial information provided to the member companies is not very thorough. Greater effort should be given to provide adequate documentation for all the data and procedures which are used for the reports provided to member companies and most importantly for the loss cost filing. It is essential that member companies have this documentation in order that they may intelligently make their individual pricing decisions. The Actuarial Standards Board Statement of Practice #41 (ASOP 41) states, "In addition to the actuarial findings, an actuarial report should identify the data, assumptions, and methods used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary's work as presented in the actuary's report."

Response: The actuarial reports supporting the loss cost filings are filed for review by actuaries and regulatory agencies in the states as well as DISB. Occasionally a state will request additional support which then is provided. Beyond the regulatory requirements, the Association responds to the needs to its members by providing the data summarized in unbiased statistical reports along with providing all filings. The Association also provides a PEL/PML model to assist members in making their construction

bond pricing decisions. Unlike larger organizations, the SFAA is a non-profit corporation and responds to the needs of the members. Any additional information beyond that required by regulatory agencies could be a superfluous cost to our members and a strain on limited resources. However, we will poll our members to determine if additional information would be useful and comply with their instructions.

Recommendations: Moreover, loss cost filings and Actuarial Committee Advisory Minutes and Agenda materials should be made available on the SFAA's website such that members have ready access to this information.

Response: The loss cost filings and Actuarial Advisory Committee Minutes and Agenda currently are readily available to members on the SFAA website. In addition, SFAA staff is available to assist members with questions and requests.

### **SUMMARY OF VIOLATIONS**

No violations were identified in this report.

## ACKNOWLEDGMENT

The courteous cooperation extended to all persons associated with this examination project by the before mentioned companies' officers is gratefully acknowledged.

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Respectfully submitted,



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FLMI, FLHC, RHU, PAHM, AIAF, AIAA, AIRC, AIC, API, ACS, AIS

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