THIRD-PARTY DATA AND MODELS (H) TASK FORCE

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Third-Party Data and Models (H) Task Force
Denver, Colorado
November 18, 2024

The Third-Party Data and Models (H) Task Force met in Denver, CO, Nov. 18, 2024. The following Task Force members participated: Michael Conway, Chair (CO); Michael Yaworsky, Vice Chair, and Anoush Brangaccio (FL); Lori K. Wing-Heier (AK); Mark Fowler represented by Richard Fiore (AL); Barbara D. Richardson and Tom Zuppan (AZ); Ricardo Lara represented by Ken Allen, Esteban Mendoza, and Chandara Phanachone (CA); Andrew N. Mais represented by Wanchin Chou (CT); Gordon I. Ito represented by Jerry Bump and Kathleen Nakasone (HI); Doug Ommen (IA); Dean L. Cameron represented by Weston Trexler and Shannon Hohl (ID); Ann Gillespie and Shannon Whalen (IL); Vicki Schmidt represented by Julie Holmes (KS); Timothy J. Temple represented by Tom Travis and Caleb Malone (LA); Michael T. Caljouw represented by Jackie Horigan (MA); Marie Grant (MD); Robert L. Carey represented by Sandra Darby (ME); Grace Arnold represented by Phil Vigliaturo (MN); Chlora Lindley-Myers represented by Cynthia Amann (MO); Jon Godfread and John Arnold and Colton Schulz (ND); D.J. Bettencourt represented by Christian Citarella (NH); Scott Kipper and Brandon Rocchio (NV); Adrienne A. Harris represented by Wayne Longmore (NY); Judith L. French represented by Dan Bradford and Matt Walsh (OH); Michael Humphreys and Shannen Logue (PA); Elizabeth Kelleher Dwyer and Beth Vollucci (RI); Michael Wise and Melissa Manning (SC); Cassie Brown and J'ne Byckovski (TX); Kevin Gaffney and Rosemary Raszka (VT); and Nathan Houdek and Andrea Davenport and Amy Malm (WI).

1. Adopted its Sept. 11 and Summer National Meeting Minutes

The Task Force met Sept. 11. During this meeting, it took the following action: 1) heard a presentation from the European Insurance and Occupational Pension Authority (EIOPA) on the supervisory review and requirements for Solvency II’s initial models (IMs).

Brangaccio made a motion, seconded by Director Wing-Heier, to adopt the Task Force’s Sept. 11 (Attachment One) and Aug. 13 (*see NAIC Proceedings – Summer 2024, Third-Party Data and Models (H) Task Force*) minutes. The motion passed unanimously.

2. Heard a Presentation on Current State Solutions to Regulatory Issues With Third Parties

Chou reported that since early 2024, the Connecticut Insurance Department (CID) has asked each insurance company that has performed sophisticated modeling to submit a separate filing of the model(s). The CID’s second approach is contracting out consultant actuaries with the Certified Specialist in Predictive Analytics (CSPA) designation in predictive modeling to help review the modeling work, which is then peer-reviewed by the CID to ensure consistency and improve the speed of review. The third approach is that the CID works with the NAIC to benefit from its predictive modeling review database. The CID has also begun to build a predictive modeling database to keep track of the modeling review work.

Byckovski reported that about four years ago, the Texas Department of Insurance (TDI) issued a commissioner's bulletin (#B-0036-20) to regulated entities and agents, reminding them that if a third party provided data, the regulated entity remains responsible for the accuracy of that data when used in rating, underwriting, and claims handling. The bulletin states that the TDI may pursue enforcement action against an insurer if the use of inaccurate third-party data harms policyholders. Like many states, the TDI licenses advisory organizations that can file supplementary rating information for review. However, there is no mechanism for third-party vendors to submit filings with the TDI unless they are licensed as an advisory organization. Last year, the TDI amended filing requirements for property/casualty (P/C) rate filings and underwriting guidelines to address insurers’ increasing use of third-party data and models, effective January 2024. Insurance companies are now required to include a description of how third-party data was used in rate making or underwriting, the name of the data vendor or source, a description of the data, such as a data dictionary, and a list of the rating variables and underwriting guidelines that reflect the use of that data. The requirements are similar for third-party models—filings must include a description of how the model output is used in setting rates and in underwriting, the name of the model vendor or source, the model name and version number, a description of the model, a description of the model input, and a list of the rating variables or underwriting guidelines that depend on that model's output.

Vigliaturo asked whether the framework for the TDI bulletin applies only to licensed third-party vendors or any third-party vendor. Byckovski responded that the bulletin holds regulated entities and agents responsible for faulty third-party data.

Commissioner Ommen asked whether filing entities include advisory organizations and entities other than the insurance companies. Byckovski responded that advisory organizations are expected to submit information on any third-party data used in the development of prospective loss costs or supplementary rating information, as well as any third-party models that might be blended into their supplementary rating information.

Darby reported that the Maine Bureau of Insurance (Bureau) has taken a similar approach to Texas and Connecticut. She noted that because the Bureau has not issued a bulletin, it has a temporary solution to the issues from data and models supplied by third parties. Third parties are sometimes treated as advisory organizations because they are just modeling telematics or one item of a rating algorithm, where the model(s) output resembles more of a categorization than actual rating factors. In this case, the Bureau has allowed third parties to file outside of the insurance company's filing so that it can perform a thorough review to ensure that requirements of Maine state law and review the model using the generalized linear model (GLM) checklist (if applicable). The Bureau always asks how a consumer can correct information if it is provided in error.

McKenney reported that the Pennsylvania Insurance Department (PID) is currently pre-vetting a draft regulation on unknown or missing risk classifications. By executive order from 1996, the PID pre-vets regulations with stakeholders before being published for the formal comment process. McKenney presented an example where rating factors are filed for the classification where the driver's age is unknown. Other examples include rating factors for unknown rating territories, marital status, years at the current residence, number of doors on a car, and number of years in business (in commercial lines). McKenney stated that this could be caused by the industry's increasing use of unregulated third-party vendors. The PID is not currently regulating third-party vendors and expressed concern about whether certain socio-economic group(s) may be missing from input databases used for modeling, resulting in unfair rate discrimination when differences in rates are based on something other than differences in expected losses and expenses.

McKenney showed examples where rating factors were assigned to an unknown risk classification category for: 1) the number of residences lived in within the prior 10 years, which may result in a 12% higher premium; 2) home dwelling age, which may result in 347% higher premium; and 3) roof type, which may result in 54% higher premium. The PID draft regulation states that if an insured characteristic is missing from a third-party vendor's database, the applicant should be asked for the missing characteristic(s). The applicant should not be rated on something that cannot be provided. Then, if the policyholder does not respond, it is okay to use unknown or missing categorization. In the PID draft regulation, lack of a credit history is generally regarded as a valid class of risk. He then stated that while several states only have advisory organizations in their laws, others define rating and advisory organizations separately. Rating organizations are issued licenses, file loss costs, class plans, rating rules, and sometimes policy forms. McKenney concluded with the following points: 1) there are over 100 unique third-party vendors used by P/C insurers; 2) more data is being used than ever before; 3) the use of the data is going to continue to increase and become even more complex; 4) validating third-party data for accuracy and bias is often not happening because of proprietary concerns; and 5) vendors are helping insurers classify risks.

Dave Snyder (American Property Casualty Insurance Association—APCIA) expressed appreciation for Pennsylvania bringing forward the issue of regulating data and models provided by third parties. The APCIA has expressed concerns about unintended consequences for consumers, such as delaying binding, certain definitions in the draft rule, and the practicality of certain other elements of the rule. However, the APCIA looks forward to further discussions with the PID. In the meantime, the APCIA urges the Task Force to see what lessons can be learned from the PID.

Nick Krafft (New York State Department of Financial Services [DFS]) discussed Insurance Circular Letter No. 7 concerning the use of artificial intelligence (AI) and external data by insurers in their underwriting and pricing processes, which the New York DFS issued in July 2024. This circular letter explains the expectations of the DFS for appropriate risk management around the use of AI and external data, focusing on three areas: 1) fairness; 2) governance and risk management; and 3) transparency and disclosure. The New York DFS developed this guidance recognizing that, as with other new technologies, insurers will be reliant on third-party vendors to help develop and implement AI systems and often develop underlying models. These third-party issues are addressed in the risk management section, where guidance makes it explicit that insurers retain responsibility at all times. Consistent with the NAIC *Model Bulletin on the Use of Artificial Intelligence Systems by Insurers* (AI Model Bulletin), the circular letter states insurers are expected to develop written standards, policies, and procedures concerning their use of external data and AI systems sourced from third parties, which includes due diligence of the third party, ongoing monitoring, as well as termination of the relationship. The circular letter guidance provides that, whenever possible, insurers should seek audit rights and require cooperation by the third party with regulatory inquiries. The fairness section of the guidance addresses how insurers can use external data in AI to avoid discrimination, which involves assessing both inputs and outputs. External data from third parties should be evaluated to determine whether it is correlated or is a proxy for a protected class in a way that may result in unfair or unlawful discrimination. Regarding model outputs, insurers should undertake a comprehensive assessment to evaluate whether underwriting or pricing guidelines rely on AI or external data, which results in unfair or unlawful discrimination. The circular letter outlines the steps insurers should go through to undertake that analysis.

3. <u>Heard a Presentation from NAMIC on Defining Third-Party Data and Model Vendor</u>

Lindsey Klarkowski (National Association of Mutual Insurance Companies—NAMIC) stated that NAMIC appreciates the Task Force's work on the issue of third-party data and model vendor regulation. She noted that at the conclusion of the Sept. 11 meeting, the Task Force indicated that it was ready to start setting forth regulatory structures for consideration. NAMIC encouraged the Task Force to revisit the scope and definition of "third-party data and model vendors." NAMIC wishes to consider categorizing models by type as a necessary first step and must define the scope of third-party data and model vendors considered since insurers use a vast spectrum of third-party data and model vendors, considering their different structures, purposes, use cases, and levels of regulatory concern over the risk that may be involved. She stated that defining where the concerns lie for the Task Force and the problem it intends to solve can help the industry provide more meaningful and targeted feedback on how these relationships currently work and steps that could be taken to improve regulatory comfort.

Klarkowski urged the Task Force to: 1) determine whether it is the intent for all third-party vendors to be licensed with each department, which may create a significant enforcement burden on staff; 2) first review NAIC guidelines already in use, for example, Guideline 1090 (Registration and Regulation of Third-Party Administrators) and Guideline 1780 (Property and Casualty Model Rating Law), which includes a definition for advisory organizations; and 3) strive for consistency within the Accelerated Underwriting (A) Working Group, Pharmaceutical Benefit Management Regulatory Issues (B) Working Group, and Privacy Protections (H) Working Group.

Chou commented that the definition of third-party within the Accelerated Underwriting (A) Working Group, the Pharmaceutical Benefit Management Regulatory Issues (B) Working Group, and the Privacy Protections (H)

Working Group only pertain to specific purposes of those work efforts, and noted that it is fair game for state insurance regulators to be concerned with regulating the whole industry, including third-party vendors and data governance practices.

Amann noted that Chapters 16, 29, and 30 of the Market Conduct Handbook go into great detail about exam standards regarding the use of external data and information collected outside of an application used in the rating of a policy, and there is a third-party questionnaire in the handbook.

Commissioner Yaworsky clarified that the Task Force is not interested in whether insurers use Google. There is less concern about the use of third parties in back-end operations or within the functioning of the company itself; rather, the concern is within the areas of rating, claims handling, settlements, and other things. Based on the wildly varying estimates of insurer damage from Hurricane Milton, it is important for the consumer's benefit to understand what AI systems are doing, how they are regulated, and that there are people who know how they work and who are making decisions.

Commissioner Ommen asked whether NAMIC had insights on how the Task Force should address whether unlicensed organizations should be filing submissions. Klarkowski responded that advisory organizations may not cover the totality of the concerns of the Task Force and urged it to determine which organizations are of concern.

Amann noted that the Catastrophe Insurance (C) Working Group finished its CAT Modeling Primer, which could be another useful source for defining third parties.

4. <u>Discussed its Next Steps</u>

Commissioner Conway stated that a survey will be issued to Task Force members to gather information about concerns arising from existing third-party models. There may be value in considering a two-step approach where the first step is to identify which risks in which markets and states are of most concern, and the second step is to determine how to develop a robust plan to develop a regulatory framework for third-party models, whether through insurers themselves or through another existing tool.

The Task Force will meet in December or shortly thereafter.

Having no further business, the Third-Party Data and Models (H) Task Force adjourned.

Member Meetings/H CMTE/2024_Fall/TF-thirdparty/Minutes thirdPartyDMTF FNM 111824.docx

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Third-Party Data and Models (H) Task Force
Virtual Meeting
September 11, 2024

The Third-Party Data and Models (H) Task Force met Sept. 11, 2024. The following Task Force members participated: Michael Conway, Chair (CO); Michael Yaworsky, Vice Chair (FL); Lori K. Wing-Heier represented by Alex Romero (AK); Mark Fowler represented by Charles Hale (AL); Barbara D. Richardson (AZ); Ricardo Lara represented by Esteban Mendoza (CA); Andrew N. Mais represented by George Bradner (CT); Gordon I. Ito represented by Lance Hirano (HI); Doug Ommen (IA); Dean L. Cameron (ID); Vicki Schmidt represented by Julie Holmes (KS); Timothy J. Temple represented by Tom Travis (LA); Kevin P. Beagan represented by Jackie Horigan (MA); Marie Grant represented by Raymond Guzman (MD); Robert L. Carey represented by Sandra Darby (ME); Grace Arnold represented by Phil Vigliaturo (MN); Chlora Lindley-Myers represented by Cynthia Amann (MO); Jon Godfread represented by Ross Hartley (ND); D.J. Bettencourt represented by Christian Citarella (NH); Scott Kipper represented by Gennady Stolyarov II (NV); Judith L. French represented by Matt Walsh (OH); Michael Humphreys (PA); Elizabeth Kelleher Dwyer (RI); Cassie Brown represented by J'ne Byckovski (TX); Kevin Gaffney (VT); and Nathan Houdek represented by Andrea Davenport (WI).

1. <u>Heard Opening Comments</u>

Commissioner Conway stated that the Task Force is continuing to discuss different regulatory models, and which components from these models could be incorporated into a regulatory structure for third parties depending on whether the Task Force chooses to move in that direction. He then introduced the speaker, Christoph Hamer (European Insurance and Occupational Pensions Authority—EIOPA), and stated that after his presentation, the Task Force would have a brief discussion about its next steps.

2. <u>Heard a Presentation from the EIOPA on the Supervisory Review and Requirements for Solvency II’s Internal Models</u>

Hamer presented an overview of the European Union’s (EU’s) risk-based framework for insurance supervision, with a particular emphasis on data and models, and provided insights into the Solvency II framework and its implementation across EU member states. The Solvency II framework offers insurers two options for calculating their capital requirements: a standard formula or an internal model (IM). The choice of an IM is subject to regulatory approval, requiring insurers to meet specific legal requirements to ensure adequate risk calculation. EIOPA plays a crucial role in this process, providing technical assistance and mediation if disagreements arise. At present, the internal model market in the EU is substantial, with 33 group IMs and 147 solo IMs across 19 National Competent Authorities (NCAs), representing 53% of the market share, highlighting the widespread adoption of sophisticated risk modeling practices in the European insurance industry.

Hamer outlined the simplified lifecycle of an IM, which includes the initial application process, approval by supervisory authorities, ongoing supervision and monitoring, management of changes to the model or risk profile, and continuous assessment of the model's appropriateness through validation and use testing. He pointed out that EIOPA's role extends beyond just regulatory oversight, also serving as a center of excellence for catastrophe modeling and data, providing crucial resources to European supervisors and insurers, including offering expertise and conducting studies, developing tools and data sets, enabling effective assessment, monitoring, and supervision of catastrophe risks, improving public awareness of catastrophe-related risks, and addressing the insurance protection gap. Regarding the regulation of third-party and vendor models, European supervisors are responsible for overseeing the full value chain, business model, and risk profile of insurers, who retain full responsibility for meeting all supervisory requirements, such that the use of third-party models or data does not exempt undertakings from internal model requirements. These undertakings must ensure that supervisors can discharge their duties over outsourced activities, including aspects of operational resilience, business continuity, and outsourcing management.

In the context of catastrophe modeling, many internal models incorporate intellectual property from specialized catastrophe model vendors. Some insurers obtain direct licenses and develop models to fit their specific risk profile, while others procure certain aspects of calculations as a service from third parties, such as brokers. Under the Solvency II framework, brokers and model vendor providers are considered part of the critical outsourcing chain. This classification extends supervisory powers to include rights for onsite inspections along the entire outsourcing chain. It also requires the development of exit plans to ensure orderly oversight of prudential supervision in case of changes in outsourcing arrangements.

Commissioner Conway then invited discussion and feedback from interested parties to help influence the development of a regulatory approach.

Having no further business, the Third-Party Data and Models (H) Task Force adjourned.

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