The cost of regulatory compliance

by Joseph F. Bieniek

While many insurance companies are focused on measuring return on investment, they often struggle with how to accurately quantify the costs related to compliance, where expenses tend to have an impact far beyond the compliance department.

Regulatory compliance-related expenses include direct costs that are most commonly associated with compliance, but they also include indirect and opportunity costs that often get overlooked when figuring expenses related to compliance products and services.

The total cost of compliance for a company cannot be measured with an exact dollar figure, but a company can control its overall compliance-related expenses and evaluate the value of maintaining compliance to the point where it can come relatively close to knowing the true overall cost associated with compliance.

Not only does this have the potential to help a company save money by letting the compliance department make more informed decisions when selecting vendors and services, it can also help put it in the best possible position to compete effectively.

When determining the total cost of compliance, a company should consider the sum total of its direct compliance costs, indirect compliance costs and opportunity compliance costs. It's important to note that both the costs of compliance *and noncompliance* should be evaluated.

Direct Costs

Direct costs are the items that are specific and easily identifiable as the cost of compliance *or the cost of noncompliance*. These include:

- *Fines and Penalties* — paid to regulatory bodies for being noncompliant;
- *Legal Fees* —necessary for settling any disputes when there are fines and penalties. Even a large company with its own legal staff will sometimes use outside counsel and incur legal fees;
- *Premium Refunds* —to insureds from the polices not correctly processed;
- *Increased Claim Payments* — the additional payments sent to claimants when claims were not previously processed properly;
- *Examination and Examiner Costs* — expenses that a company pays to the state for the review of their records;
- *Products Purchased* — products or services purchased to help the company comply with state requirements;
- *Examination Coordinator* —time spent by an individual assigned to ensure exam runs smoothly and who responds to all examiner requests; and
- *Staff Devoted to Compliance* — including any individuals assigned to helping the company be compliant, either part-time or full-time.

Indirect Costs

Indirect costs include money spent elsewhere, yet still related to compliance. Since these expenses can't always be quantified, an estimate often has to suffice. Examples of indirect compliance costs are:

- *Adverse Publicity* — negative publicity and the damaged reputation that can stem from an enforcement action;
- *Review and Defense of Class Action Lawsuits* — research time and expense involved in allegations against the company due to published examination results;
- *Time Spent on Remedial Actions* — particularly when a further review of a company's book of business has been ordered by an insurance department;
- *Premium Under-Charges* — the additional costs incurred when initial premium amounts are misrated;
- *Claim Overpayments* — overpayments that are not retrievable from the policyholder;
- *Internal Staff Devoted Elsewhere* — the time noncompliance staff devotes to compliance issues or supplying information related to compliance needs;
- *Processes & Procedures in Handling Insureds & Claimants* — all aspects related to compliance

activities, including training, travel and communication; and

- *Storage Costs* — costs to store documents, either in hard copy or electronically, related to an examination.

Opportunity Costs

Opportunity costs occur when there is missed revenue or investment because resources were deployed for alternative purposes. Opportunity costs are the most difficult to assign a dollar value to. These items include:

- *Lack of Proper Rate Due to Disciplinary Action*— premium rates generally include expenses/costs plus a profit margin, but companies are not allowed to include fines or penalties in their ratemaking cost allocations;
- *Reduction in Investment Assets/Returns*— investment returns can decline — and net income deteriorate — when funds are re-directed to compliance efforts;
- *Stock Price/Dividend/Company Value* — potential lowered stock price or company value that occurs when a noncompliant company does not manage its top and bottom lines effectively nor compete at the best of its abilities;
- *Staff Time Spent Elsewhere* — additional costs that accrue when production staff spend time on tasks not associated with their normal business routines; and
- *Possible Suspension or Revocation of a License or Certificate of Authority* — although suspensions or revocations occur rarely, the possibility should not be overlooked.

Compliance Costs With No Fines/Penalties

A company that successfully comes through an examination without a fine or penalty has avoided at least 8 of the 21 potential costs outlined above. These are: Fines and Penalties; Legal Fees; Adverse Publicity; Review and Defense of Class Action Lawsuits; Lack of Proper Rate Due to a Disciplinary Action; Reduction in Investment Assets/Returns; Possible Suspension or Revocation of License or Certificate of Authority; and Stock Price/Dividend/Company Value.

A company operating in this area is in a much better position to control its cost of compliance.

Compliance Costs When There Are Zero Errors

A company found to have no errors in its examination further reduces its compliance costs. The costs avoided include the eight listed above plus: Premium Refunds; Increased Claim Payment; Time Spent on Remedial Actions; Premium Under-Charges; and Claim Overpayments.

This is significant. The number of cost items is now narrowed down to:

Direct Costs

- Exam and Examiner Costs
- Products Purchased
- Exam Coordinator
- Staff Devoted to Compliance

Indirect Costs

- Internal Staff Devoted Elsewhere
- Processes & Procedures in Handling Insureds & Claimants
- Storage Costs

Opportunity Costs

- Staff Time Spent Elsewhere

A company that is totally compliant realizes some significant benefits. Almost all of its cost items fit into the "direct costs" category, which are usually identified with a specific dollar amount assigned to them. This means the company can manage its cost more effectively and allocate its resources more efficiently.

When costs associated with noncompliance are eliminated, a company can better determine its premium rate. When proper rates are established, the company can more accurately gauge its profit loading and enhance its competitive position.

Knowing where your costs are can help insurers manage their operation more effectively and stay compliant – it all comes full circle. ■

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