FIO recommendations on modernizing insurance regulation in the US

Time for the industry to act

The Federal Insurance Office (FIO) has submitted to Congress its long-awaited recommendations to modernize insurance regulation in the United States, as required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).¹

In the document, How to Modernize and Improve the System of Insurance Regulation in the United States (the Report), the FIO recommends changes in several areas, including capital adequacy, safety and soundness, and marketplace regulation.

Significantly, the Report highlights what the FIO believes to be weaknesses in the current state-based regulatory system and the states’ inability, to date, to effectively address the findings of the June 2009 US Department of the Treasury white paper, Financial Regulatory Reform: A New Foundation, which outlined principles to measure insurance regulatory reform.²

In the Report, the FIO makes a pointed suggestion for federal involvement if the states do not address its recommendations, stating that, “... should the states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement.”


Recommendations for state reforms

The FIO recommendations emphasize the need for states to improve the consistency of regulations, the uniformity of enforcement and the level of transparency of their oversight. From the 18 recommendations for near-term state reforms, the following areas are likely to be of greatest interest to large insurers.

Solvency, Recommendations 1 through 4

Despite efforts by the states to establish uniform capital standards and consistent solvency oversight, the Report observes that significant issues remain. All states have adopted risk-based capital standards, but these standards are not applied uniformly across states and to all classes of insurers. The Report gives particular attention to the use of captives and special purpose vehicles, expressing concern that some insurers use captives to lower their capital requirements. To address this concern, the Report recommends that the rules governing asset transfer be consistent and calls for greater oversight transparency from state to state.

The issue on captives is consistent with recent concerns raised by other regulatory bodies, for example the Securities and Exchange Commission and the New York Department of Financial Services.

Reserving, Recommendation 5

As reflected in the Report, state regulators have proposed a system of principles-based reserving that relies on an insurer’s internal models. The FIO is concerned that the interpretation and enforcement of principles-based reserving will be uneven across states and thus introduce more inconsistency and diminish transparency. The Report states that regulators will need significantly more technical expertise and resources to evaluate the many different reserve models used across the insurance industry.

Corporate governance, Recommendation 6

The Report notes that no state laws or regulations are in place specific to the governance of insurance companies, yet such oversight is becoming increasingly necessary as insurers grow in size, geography and complexity. The FIO recommends that state regulators adopt qualification standards that require directors and officers to have the expertise needed to assess growth strategies and risks to the enterprise.

The costs of today’s insurance regulations

The Report suggests the multiplicity of regulatory regimes and the lack of uniformity across states penalize consumers, insurers and the international community. It cites in support a 2009 McKinsey study that found the cost of the state-based regulatory system to be roughly seven times greater for an insurer operating in the US than for an insurer in the United Kingdom. The Report takes the position that, “It would be much less costly, much less prone to arbitrage and much easier to negotiate internationally for more efficient and effective oversight to the insurance sector if US insurance regulation had greater uniformity and predictability.”

Supervision of global institutions, both US companies as well as foreign insurers with large US operations, requires international cooperation, and a single federal entity would be better able than the states to participate in international standard setting, according to the Report. Dodd-Frank provides the FIO with a number of authorities, including coordinating federal efforts, developing federal policy on international insurance matters and representing the United States in the International Association of Insurance Supervisors.

Group supervision, Recommendations 7 and 8
The FIO observes that states are constrained in their oversight of multi-jurisdictional insurance groups such as large, complex global insurance firms, which may prevent them from protecting against insolvency. The Report recommends supervisory colleges should play an important role in resolving the issue of group supervision within the US.

Consumer protection and market oversight, Recommendations 13 and 14
Dodd-Frank created the Consumer Financial Protection Bureau, which specifically excludes insurers from its scope. The Report includes several recommendations to improve consumer protection from insurance companies. To protect consumers purchasing annuities, the Report recommends all states adopt the NAIC’s Suitability in Annuity Transactions Model Regulation. This model law includes requirements for a producer to have reasonable grounds for recommending an annuity to a consumer and to be adequately trained in the provisions of annuities. In the area of training, the Report notes a lack of consistency from state to state and the need for an insurer to take multiple examinations on similar topics. The FIO observes that the rigor and breadth of examinations also differ among states, raising concerns about effective consumer protection. The Report calls for state regulators to coordinate market conduct examinations and follow the NAIC Market Regulation Handbook.

Potential areas for direct federal involvement in reform
While the Report does not recommend the state-based system be replaced with a federal one, it does identify nine areas where the FIO believes federal involvement is warranted, indicating that federal involvement might follow one of two paradigms.

1. Federal standards implemented by the states. The federal government would develop and adopt national rules that preempt state law, but leave direct enforcement of the rules and standards to the states.

2. Direct federal regulation. The federal government would directly develop, regulate and enforce national rules and standards. These rules might cover the entire insurance industry or selected areas, such as multi-state producer licensing, a particular line of insurance or insurers of a specific size or complexity. Another possibility would allow firms to opt into a federal charter that allows them to follow federal rather than state regulations.

How should insurers respond?
The FIO recommendations are not directives and it is impossible to forecast whether and to what extent Congress might act should the state regulators not adequately address the FIO recommendations. However, EY recommends that insurers begin to prepare for possible change in the following ways to strengthen their position—no matter when or in what form the change may occur.

- Review and identify the FIO recommendations that would have a significant impact on the business and engage in the policy debate concerning modernization in those contexts.
- Assess governance frameworks and develop an Own Risk Solvency Assessment to use in discussing critical risks and threats to the company with regulators, senior management and the board of directors.
- Explore ways to improve risk management and capital assessment capabilities, such as a risk governance and committee structure and stress and scenario forecasting. These capabilities are expected to be key components of any likely regulatory change. Current leading industry practices are also apt to be a foundation for change. In the short term, insurers can benchmark themselves to their peers to determine areas for improvement in anticipation of new regulatory requirements.
- Identify enhancements to systems, processes and controls that will be needed to produce robust risk and capital adequacy information in a timely fashion, for both regulatory reporting and for risk governance.
- Review the use of captives to ensure that the regulatory and economic capital positions of the group are not compromised. A proactive assessment will help mitigate eventual regulatory scrutiny.

Conclusion
The Report summarizes perceived weaknesses the FIO observed in its review of the current state-based regulatory system, rather than arguing for any immediate large-scale federal involvement in insurance regulation. Certain insurers, such as complex, multinational, mortgage and annuity writers are singled out in the report and should be aware that they are in the FIO’s policy spotlight. While the FIO gives credit to the modernization efforts being led by the NAIC, it also clearly indicates that Congress should seriously consider greater federal involvement if further meaningful change is not made in a reasonable timeframe.
Areas of near-term reform for the states

Capital adequacy and safety/soundness

1. For material solvency oversight decisions of a discretionary nature, states should develop and implement a process that obligates the appropriate state regulator to first obtain the consent of regulators from other states in which the subject insurer operates.

2. To improve consistency of solvency oversight, states should establish an independent, third-party review mechanism for the National Association of Insurance Commissioners Financial Regulation Standards Accreditation Program.

3. States should develop a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives.

4. State-based solvency oversight and capital adequacy regimes should converge toward best practices and uniform standards.

5. States should move forward cautiously with the implementation of principles-based reserving and condition it upon: (1) the establishment of consistent, binding guidelines to govern regulatory practices that determine whether a domestic insurer complies with accounting and solvency requirements; and (2) attracting and retaining supervisory resources and developing uniform guidelines to monitor supervisory review of principles-based reserving.

6. States should develop corporate governance principles that impose character and fitness expectations on directors and officers appropriate to the size and complexity of the insurer.

7. In the absence of direct federal authority over an insurance group holding company, states should continue to develop approaches to group supervision and address the shortcomings of solo entity supervision.

8. State regulators should build toward effective group supervision by continued attention to supervisory colleges. Reform of Insurer Resolution Practices.

Reform of Insurer resolution practices

9. States should: (1) adopt a uniform approach to address the closing out and netting of qualified contracts with counterparties; and (2) develop requirements for transparent financial reporting regarding the administration of a receivership estate.

10. States should adopt and implement uniform policyholder recovery rules so that policyholders, irrespective of where they reside, receive the same maximum benefits from guaranty funds.

Marketplace regulation

11. States should assess whether or in what manner marital status is an appropriate underwriting or rating consideration.

12. State-based insurance product approval processes should be improved by securing the participation of every state in the Interstate Insurance Product Regulation Commission (IIPRC) and by expanding the products subject to approval by the IIPRC. State regulators should pursue the development of nationally standardized forms and terms, or an interstate compact, to further streamline and improve the regulation of commercial lines.

13. In order to fairly protect consumers in all parts of the United States, every state should adopt and enforce the National Association of Insurance Commissioners Suitability in Annuities Transactions Model Regulation.

14. States should reform market conduct examination and oversight practices and: (1) require state regulators to perform market conduct examinations consistent with the National Association of Insurance Commissioners Market Regulation Handbook; (2) seek information from other regulators before issuing a request to an insurer; (3) develop standards and protocols for contract market conduct examiners; and (4) develop a list of approved contract examiners based on objective qualification standards.

15. States should monitor the impact of different rate regulation regimes on various markets in order to identify rate-related regulatory practices that best foster competitive markets for personal lines insurance consumers.

16. States should develop standards for the appropriate use of data for the pricing of personal lines insurance.

17. States should extend regulatory oversight to vendors that provide insurance score products to insurers.

18. States should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.
Areas for direct federal involvement in regulation

1. Federal standards and oversight for mortgage insurers should be developed and implemented.

2. To afford nationally uniform treatment of reinsurers, FIO recommends that Treasury and the United States Trade Representative pursue a covered agreement for reinsurance collateral requirements based on the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Regulation.

3. FIO should engage in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers.

4. The National Association of Registered Agents and Brokers Reform Act of 2013 should be adopted and its implementation monitored by FIO.

5. FIO will convene and work with federal agencies, state regulators, and other interested parties to develop personal auto insurance policies for US military personnel enforceable across state lines.

6. FIO will work with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering personal lines products.

7. FIO will study and report on the manner in which personal information is used for insurance pricing and coverage purposes.

8. FIO will consult with Tribal leaders to identify alternatives to improve the accessibility and affordability of insurance on sovereign Native American and Tribal lands.

9. FIO will continue to monitor state progress on implementation of Subtitle B of Title V of the Dodd-Frank Act, which requires states to simplify the collection of surplus lines taxes, and determine whether federal action may be warranted in the near term.
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