

HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES

FEDERAL INSURANCE OFFICE, U.S. DEPARTMENT OF THE TREASURY

Completed pursuant to Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act

DECEMBER 2013



TABLE OF CONTENTS

I. INTRODUCTION	1
Structure of the Report.....	4
Recommendations for Modernization of Insurance Regulation in the United States	5
Areas of Near-Term Reform for the States.....	6
Areas for Direct Federal Involvement in Regulation	7
Potential Federal Solutions to States’ Failure to Modernize and Improve	8
II. A BRIEF HISTORY OF THE REGULATION OF THE UNITED STATES INSURANCE INDUSTRY	11
Early Era of Insurance Regulation and the Limitation on Federal Authority.....	11
Box 1: The National Association of Insurance Commissioners (NAIC)	11
Early Calls for Federal Regulation of Insurance	13
The Case of <i>South-Eastern Underwriters</i> , Federal Authority to Regulate Insurance, and the McCarran-Ferguson Act.....	14
The Crises of Insurer Insolvencies, Congressional Reaction, and State Regulatory Responses.....	15
Recent Proposals for Federal Regulation of Insurance to Promote Uniformity.....	16
The Financial Crisis.....	18
Box 2: AIG.....	18
Box 3: Assistance to the Insurance Industry during the Financial Crisis.....	20
Financial Regulatory Reform	21
III. PRUDENTIAL OVERSIGHT	23
The Solvency Framework.....	23
Box 4: Europe’s Insurance Regulatory Regime – Solvency II.....	26
Capital Standards	28
Box 5: Credit Rating Agencies, Financial Guaranty Insurance, and the Financial Crisis.....	30
Reserving	35
Credit for Reinsurance	37
Corporate Governance – Director and Officer Suitability and Fitness.....	38
Group Supervision	39
Resolution of Insolvent Insurers	42

How To Modernize And Improve The System Of Insurance Regulation In The United States

Receivership	43
Guaranty Funds	44
IV. MARKETPLACE OVERSIGHT, CONSUMER PROTECTION AND ACCESS TO INSURANCE	46
Producer Licensing	46
Box 6: Marriage and Insurance	48
Product Approval	48
Box 7: Personal Auto Policies for Service Members	49
Box 8: Sale of Annuities to Suitable Consumers	51
Market Conduct Regulation	52
Rate Regulation	54
Box 9: Forms of Rate Regulation	55
Risk Classification	56
Box 10: Access of Native Americans to Insurance	57
Nonadmitted and Reinsurance Reform Act of 2010	58
Natural Catastrophes	59
V. TAKING ACCOUNT OF REGULATORY REFORM	62
VI. CONCLUSION	65

GLOSSARY OF ACRONYMS

Actuarial Guideline 38	AG 38
AIG Financial Products	AIG FP
AIG Securities Lending Corporation	AIGSLC
American Council of Life Insurers	ACLI
American International Group, Inc	AIG
Board of Governors of the Federal Reserve System.....	Federal Reserve
California Earthquake Authority	Authority
Capital Purchase Program	CPP
Commercial Paper Funding Facility.....	CPFF
Common Framework for the Supervision of Internationally Active Insurance Groups.....	ComFrame
Consumer Financial Protection Bureau	CFPB
Council of Insurance Agents and Brokers.....	CIAB
Credit Default Swap.....	CDS
Credit Rating Agencies.....	CRAs
Defense of Marriage Act	DOMA
Department of Housing and Urban Development	HUD
Department of the Treasury	Treasury
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.....	Dodd-Frank Act
European Insurance and Occupational Pensions Authority.....	EIOPA
European Union	EU
Federal Deposit Insurance Corporation	FDIC
Federal Emergency Management Agency.....	FEMA
Federal Insurance Office	FIO
Federal Insurance Office Act of 2010.....	FIO Act
Financial Analysis Working Group.....	FAWG
Financial Stability Assessment Program	FSAP
Financial Stability Board	FSB
Financial Stability Committee	FSC
Financial Stability Oversight Council	Council
Global Receivership Information Database.....	GRID
Global Systemically Important Insurers	G-SIIs
Government Accountability Office.....	GAO
Government Sponsored Enterprises	GSEs
Gramm-Leach-Bliley Act	GLBA
International Association of Insurance Supervisors	IAIS
International Monetary Fund.....	IMF
Interstate Insurance Product Regulation Commission	IIPRC
Life and Health	L/H
National Association of Insurance Commissioners	NAIC
NAIC Credit for Reinsurance Model Law and Regulation.....	Model Collateral Law
NAIC Financial Regulation Standards Accreditation Program.....	Accreditation Program
NAIC Model Insurance Holding Company System Regulatory Act and Regulation.....	Holding Company Model Act
NAIC Suitability in Annuity Transactions Model Regulation	Model Suitability Regulation
National Association of Registered Agents and Brokers.....	NARAB
National Conference of Insurance Guaranty Funds	NCIGF
National Flood Insurance Program.....	NFIP

National Insurance Producer Registry	NIPR
National Organization of Life & Health Insurance Guaranty Associations.....	NOLHGA
New York Department of Financial Services.....	NYDFS
Non-admitted and Reinsurance Reform Act.....	NRRA
Office of Thrift Supervision.....	OTS
Own Risk and Solvency Assessment.....	ORSA
Principles Based Reserving	PBR
Producer Licensing Model Act	PLMA
Property and Casualty.....	P/C
Qualified Financial Contracts.....	QFCs
Quantitative Capital Standard.....	QCS
Residential Mortgage Backed Securities	RMBS
Risk-based capital.....	RBC
Secretary of the Treasury	Secretary
Securities and Exchange Commission	SEC
Securities Valuation Office	SVO
Solvency Modernization Initiative.....	SMI
Special Purpose Vehicle	SPV
Standard Valuation Law	SVL
Statutory accounting principles	SAP
State Modernization and Regulatory Transparency Act	SMART Act
System for Electronic Rate and Form Filing.....	SERFF
Term Asset-Backed Auction Loan Facility.....	TALF
Terrorism Risk Insurance Act.....	TRIA
United States Trade Representative.....	USTR
Value at Risk	VaR

I. INTRODUCTION

By any measure, insurance is a significant sector of the U.S. economy. Insurance premiums in the life and health (L/H) and property and casualty (P/C) insurance sectors totaled more than \$1.1 trillion in 2012,¹ or approximately 7 percent of gross domestic product.² In the United States, insurers directly employ approximately 2.3 million people, or 1.7 percent of nonfarm payrolls.³ More than 2.3 million licensed insurance agents and brokers hold more than 6 million licenses.⁴ Moreover, as of year-end 2012, the L/H and P/C sectors reported \$7.3 trillion in total assets⁵ – roughly half the size of total assets held by insured depository institutions.⁶ Of the \$7.3 trillion in total assets, \$6.8 trillion were invested assets.⁷

The business of insurance in the United States is primarily regulated at the state level. Insurance laws are enacted by state legislators and governors and are implemented and enforced by state regulators. Broadly speaking, state regulation is divided into prudential regulation (frequently referred to as “solvency” regulation) and marketplace regulation. Prudential regulation consists of oversight of an insurer’s financial condition and its ability to satisfy policyholder claims. Marketplace regulation governs an insurer’s business conduct, such as the pricing of premiums, advertising, minimum standards governing the terms of insurance policies, licensing of insurance agents and brokers (producers), together with general issues of consumer protection and access to insurance.

Although reforms to solvency and marketplace regulation are continually discussed, for over a century a centerpiece of the debate among policymakers and industry leaders over modernizing insurance regulation has been the extent to which the federal government should be involved in insurance regulation. These conversations have generally focused on the question of whether a state-based system can answer the regulatory demands of a national, and increasingly global, insurance market. Proponents of modernizing insurance regulation through federal involvement have noted that the current state-based system does not impose the uniformity necessary for the U.S. insurance market to function efficiently. They explain that state regulation is often duplicative or inconsistent, that the multiplicity of jurisdictions makes state regulators more prone to “capture,” and that differences in standards between the states provide opportunities for arbitrage, if not a race to the bottom. Moreover, proponents of federal involvement contend that limitations on the jurisdictional reach of states’ legal authority impede effective regulation of entities whose businesses span multiple jurisdictions and sectors.

Those who favor continuation of the current regime of state regulation counter that much of the business of insurance is local in nature and generally does not lend itself to uniform national regulation, and that states are better positioned to respond to consumer complaints. They add that mechanisms for cooperation and achieving uniformity already exist among the states, and that a state-based system provides better opportuni-

1 SNL Financial LC (April 25, 2013).

2 See Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/national/index.htm#gdp> (reporting – via the “Current-dollar and ‘real’ GDP” hyperlink – 2012 nominal GDP of \$15,684.8 billion).

3 Department of Labor, Bureau of Labor Statistics, http://data.bls.gov/timeseries/CES5552400001?data_tool=XGtable (data extracted on April 5, 2013).

4 National Insurance Producer Registry (NIPR), *2012 Annual Report*, 9, available at http://www.nipr.com/documents/2012_NIPR_Annual_Report.pdf.

5 SNL Financial LC (April 25, 2013).

6 Federal Deposit Insurance Corporation (FDIC), *Quarterly Banking Profile*, 7 (Fourth Quarter 2012), available at <http://www2.fdic.gov/qbp/2012dec/qbp.pdf> (reporting \$14.5 trillion of total assets held by FDIC-insured institutions).

7 SNL Financial LC (April 25, 2013) (the \$6.8 trillion of invested assets includes separate account assets held by L/H insurers).

ties for experimentation so that the best ideas developed in one jurisdiction can be adopted and replicated in others. They also assert that, by and large, state regulation works well.

By drawing attention to the supervision of diversified complex financial institutions such as American International Group, Inc. (AIG), the financial crisis added another dimension to the debate on regulating the insurance industry. The crisis demonstrated that insurers, many of which are large, complex, and global in reach, are integrated into the broader U.S. financial system and that insurers operating within a group may engage in practices that can cause or transmit severe distress to and through the financial system. AIG's near-collapse revealed that, despite having several functional regulators, a single regulator did not exercise the responsibility for understanding and supervising the enterprise as a whole.⁸ The damage to the broader economy and to the financial system caused by the financial crisis underscored the need to supervise firms on a consolidated basis, to improve safety and soundness standards so as to make firms less susceptible to financial shocks, and to better understand and regulate interconnections between financial companies.⁹

As part of the federal government's response to the financial crisis, Congress passed and President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (Pub. L. 111-203) in July 2010. The Dodd-Frank Act established the Financial Stability Oversight Council (Council), which has the responsibility for monitoring emerging risks to the U.S. financial system and has the authority to determine that nonbank financial companies shall be subject to supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) and prudential standards. Subtitle A of Title V of the Dodd-Frank Act, entitled the Federal Insurance Office Act of 2010 (31 U.S.C. §§ 313-14) (FIO Act), established the Federal Insurance Office (FIO) in the U.S. Department of the Treasury (Treasury). The statute provides FIO with the following authorities:

1. Monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system;
2. Monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products regarding all lines of insurance, except health insurance;
3. Recommend to the Council that it designate an insurer, including the affiliates of such insurer, as an entity subject to regulation as a nonbank financial company supervised by the Federal Reserve;
4. Assist the Secretary of the Treasury (the Secretary) in administering the Terrorism Insurance Program established in the Treasury under the Terrorism Risk Insurance Act of 2002;
5. Coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (IAIS) and assisting the Secretary in negotiating covered agreements;¹⁰

8 AIG was regulated at the holding company level by the former Office of Thrift Supervision.

9 For discussion of consolidated supervision of U.S. insurance groups, see: IMF, United States: *Publication of Financial Sector Assessment Program Documentation — Detailed Assessment of Observance of IAIS Insurance Core Principles* (2010).

10 In the FIO Act, 31 U.S.C. § 313(r)(2), a "covered agreement" is defined as a "bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that – (A) is entered into between the United States and one or more foreign governments, authorities, or regulator entities; and (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."

How To Modernize And Improve The System Of Insurance Regulation In The United States

6. Determine whether State insurance measures are preempted by covered agreements;
7. Consult with the States (including State insurance regulators) regarding insurance matters of national importance and prudential insurance matters of international importance; and
8. Perform such other related duties and authorities as may be assigned to FIO by the Secretary.

In addition, the Dodd-Frank Act assigns certain duties to the Director of FIO. Pursuant to Title I of the Dodd-Frank Act, the Director serves as a nonvoting member of the Council. Under Title II, the affirmative approval of the Director, along with a vote of two-thirds of the Governors of the Federal Reserve, is required before the Secretary may make a determination on whether to seek the appointment of the Federal Deposit Insurance Corporation (FDIC) as receiver of an insurance company.

Title V of the Dodd-Frank Act also requires the FIO Director to “conduct a study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States.”¹¹ This Report responds to the Congressional directive.

To support this study and Report, FIO has consulted extensively with various stakeholders. On October 17, 2011, FIO published a notice in the Federal Register asking the public to submit comments on the considerations and factors listed in Title V:

- Systemic risk regulation with respect to insurance.
- Capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk.
- Consumer protection for insurance products and practices, including gaps in State regulation.
- The degree of national uniformity of State insurance regulation.
- The regulation of insurance companies and affiliates on a consolidated basis.
- International coordination of insurance regulation.

In addition, Title V states that the Report must also examine:¹²

- The costs and benefits of potential Federal regulation of insurance across various lines of insurance (except health insurance).
- The feasibility of regulating only certain lines of insurance at the Federal level, while leaving other lines of insurance to be regulated at the State level.
- The ability of any potential Federal regulation or Federal regulators to eliminate or minimize regulatory arbitrage.
- The impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential Federal regulation of insurance.
- The ability of any potential Federal regulation or Federal regulator to provide robust consumer protection for policyholders.
- The potential consequences of subjecting companies to a Federal resolution authority, including the effects of any Federal resolution authority -
 - On the operation of State insurance guaranty fund systems, including the loss of guaranty fund coverage if an insurance company is subject to a Federal resolution authority;
 - On policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims;

¹¹ 31 U.S.C. § 313(p).

¹² 31 U.S.C. § 313(p)(3).

- In the case of life insurance companies, on the loss of the special status of separate account assets and separate account liabilities; and
- On the international competitiveness of insurance companies.
- Such other factors as the Director determines necessary or appropriate, consistent with the principles set forth in the prior paragraph.

FIO received nearly 150 written comments, which are available online at treasury.gov/initiatives/fio. In November and December 2011, FIO had an initial round of consultations with nearly 40 different insurance sector participants, ranging from insurance regulators, to insurers, to consumer advocates. On December 9, 2011, FIO hosted a conference at the Treasury where participants representing the interests of consumers, insurers and reinsurers, producers, and academics discussed regulatory modernization. Topics included marketplace oversight and licensing, international developments, and prudential oversight. FIO's study and consultations continued throughout 2012 and 2013. This Report reflects some of the many issues and topics raised by stakeholders throughout the consultative process, including through written comments, at the Treasury conference, and also through FIO's direct engagement with federal, state, and international supervisors.

Structure of the Report

This Report is divided into five principal sections. Section I, the introduction, presents the recommendations for modernizing insurance regulation in the United States. This discussion also includes a general assessment of whether federal involvement is necessary in the regulation of insurance and, if so, what manner that involvement should take.

Section II describes the history of insurance regulation in the United States, highlighting significant events in its development. The historical perspective helps frame the current debates on modernization by illustrating the continuing debate, raised in different contexts and time periods, as to whether federal or state insurance regulation would best address the need for improved uniformity and oversight. This section begins by discussing the advent of state insurance regulation in the 19th century, key Supreme Court decisions such as *Paul v. Virginia* (1868) and *United States v. South-Eastern Underwriters* (1944), the passage of the McCarran-Ferguson Act in 1945, the reaction of state regulators and Congress to insolvency crises in the 1960s through the early 1990s, and the passage, in 1999, of the Gramm-Leach-Bliley Act (GLBA). This section also explores state regulators' reaction to Congressional interest in insurance regulation and outlines recent proposals for federal oversight. It concludes by discussing the financial crisis, reforms enacted under the Dodd-Frank Act, and the creation of FIO.

Section III presents the analysis underlying the recommendations regarding prudential oversight issues. It reviews the framework by which insurers are evaluated and regulated for solvency as these topics are currently being discussed by the U.S. and the international regulatory communities, including the European Union (EU) and the IAIS. More specifically, this section analyzes the approaches state regulators use to assess an insurer's capital adequacy, together with discretionary practices and emerging issues on reserving and the regulation of captives. This section also discusses corporate governance matters and group supervision in the context of national and international reforms. Finally, this section evaluates current approaches to insurer resolution and guaranty fund processes.

Section IV presents the analysis supporting the recommendations concerning marketplace oversight, focusing on market and consumer issues that have been the subject of the recurring debate on national regulatory uniformity. Some of the principal topics in this area are: (1) multi-state licensing for insurance producers; (2) the state-based insurance product approval processes; (3) examinations of an insurer's market conduct; (4) rate regulation; and (5) insurance scoring and risk classification practices for personal lines insurance consumers. This section also reviews the states' regulatory treatment

of insurance lines affected by natural catastrophes, the accessibility of insurance to Native American communities, collection of taxes for multi-state surplus lines placements, and suitability standards for the sale of annuity products.

Section V discusses insurance modernization in the context of basic principles of regulatory reform. The Report comprehensively addresses all of the statutory considerations and factors, but not in a serial or individual manner.

Recommendations for Modernization of Insurance Regulation in the United States

For over a century, the debate over reform of insurance regulation in the United States has focused largely on the practical and legal limitations of the state-based insurance regulatory system. The absence of uniformity in the U.S. insurance regulatory system creates inefficiencies and burdens for consumers, insurers, and the international community. For example, per dollar of premium, the costs of the state-based insurance regulatory system are approximately 6.8 times greater for an insurer operating in the United States than for an insurer operating in the United Kingdom, and increase costs for P/C insurers by \$7.2 billion annually and for life insurers by \$5.7 billion annually.¹³ The need for uniformity and the realities of globally active, diversified financial firms compel the conclusion that federal involvement of some kind in insurance regulation is necessary. Regulation at the federal level would improve uniformity, efficiency, and consistency, and it would address concerns with uniform supervision of insurance firms with national and global activities.

The increasingly international dimension of the insurance marketplace, in and of itself, is also an important consideration. U.S. firms are not the only ones with a global reach. Non-U.S. firms have significantly expanded market share around the world, including in the U.S. direct and reinsurance markets, a trend that likely will continue because of the size of the U.S. insurance market. Insurance regulatory issues will increasingly require international attention and cooperation. The federal government's predominant role in foreign affairs is one reason for the necessity of a federal presence in insurance regulation. It would be much less costly, much less prone to arbitrage, and much easier to negotiate internationally for more efficient and effective oversight of the insurance sector if U.S. insurance regulation had greater uniformity and predictability.

The limitations inherent in a state-based system of insurance regulation, however, do not necessarily imply that the ideal solution would be for the federal government to displace state regulation completely. The business of insurance involves offering many products that are tailored for and delivered at a local level. For the most part, effective delivery of the product will require local knowledge and relationships, and local regulation. Moreover, establishing a new federal agency to regulate all or part of the \$7.3 trillion insurance sector would be a significant undertaking. The personnel, resources, and institutional expertise needed to execute such an endeavor at a professional and rigorous level would, of necessity, require an unequivocal commitment from the legislative and executive branches of the U.S. government.

In light of these considerations, this Report concludes that the proper formulation of the debate at present is not whether insurance regulation should be state or federal, but whether there are areas in which federal involvement in regulation under the state-based system is warranted. Reframed in this manner, the basic question with respect to reforming any aspect of insurance should be whether federal involvement is warranted at this time and, if so, in what areas. The necessity for federal involvement should depend on assessment of questions such as whether states can take measures to regulate effec-

¹³ McKinsey & Company, "Improving Property and Casualty Insurance Regulation In the United States," (April 2009).

How To Modernize And Improve The System Of Insurance Regulation In The United States

tively and with uniformity, the degree of the national or federal interest, and the nexus of the issues and the firms with the global marketplace.

If the answer to the first inquiry is that federal involvement is warranted, the inquiry then turns to what kind of federal involvement would best provide for attaining the policy objectives. Federal involvement can take many forms, ranging from direct regulation to standard-setting or operating a program that supports or replaces an otherwise failed insurance market. In all events, federal involvement should be targeted to areas in which that involvement would solve problems resulting from the legal and practical limitations of regulation by states, such as the need for uniformity or the need for a federal voice in U.S. interactions with international authorities.

In light of the foregoing, FIO believes that, in the short term, the U.S. system of insurance regulation can be modernized and improved by a combination of steps by the states and certain actions by the federal government. The recommendations are as follows.

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

- 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*

How To Modernize And Improve The System Of Insurance Regulation In The United States

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 U.S. 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.*

Potential Federal Solutions to States' Failure to Modernize and Improve

As detailed further in this Report, many of the areas for which FIO recommends that there be reform of the state regulatory system relate to subject matter areas in which the states already have been working to make changes. For a variety of reasons, however, progress has been uneven despite the absence of any dispute about the need for change. As a result, should the states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement.

The precise manner of federal involvement is a matter for Congress to determine. Recent experience suggests that proposals for federal involvement have fallen into two paradigms: (1) the federal government serving as a coordinating body that also adopts national rules and standards that would preempt state law, but that would leave direct enforcement of the rules and standards to the states; and (2) direct federal regulation of selected areas or aspects of the insurance industry, whether it be oversight of one element of the distribution chain (*e.g.*, multi-state producer licensing) or a particular line of insurance.

Federal Standards Implemented by the States

The first paradigm is for the federal government to serve as a coordinating and facilitating body to assist states with developing national standards and rules. One example of this approach occurred in 1990, when Congress mandated the development of standard benefit designs for Medicare supplement policies. This approach imposed uniform product design on so-called "Medi-gap" policies, thereby enabling consumers to comparison shop. Under this approach, Congress permitted the states to develop the product standards promulgated as regulation by the U.S. Department of Health and Human Services Center for Medicare and Medicaid Services.

Another example is the National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB II), which is presently under consideration by Congress. Under NARAB II, a commission would be established and guided by a board comprised of state regulators and producers. The National Association of Registered Agents and Brokers (NARAB) would be responsible for issuing multi-state licenses to producers which would preempt the application of any state law or regulation for purposes of licensing and continuing education. Standards will be established, in part, by state regulators, and producers will benefit from one centralized licensing location and process.

Other reform proposals have resembled the foregoing examples of federal/state collaboration. Congress explored one such approach in 2004, when two members of Congress offered a discussion draft known as the "State Modernization and Regulatory Transparency Act," or the "SMART Act." This discussion draft put forth a comprehensive insurance reform proposal that would have provided for the development of national standards and coordinated regulation. It proposed that uniform standards would be enforced at the state level. While the states would develop the uniform standard, each uniformity requirement included an enforcement mechanism to incentivize state participation. For example, failure to streamline licensing for producers would result in preemption of the law of the state that failed to adopt the uniformity standard. This discussion draft, if introduced and adopted, would have

required uniform standards for issues that remain a challenge today: producer licensing, product approval, and surplus lines tax remittance, among others.

One proposed reform has been to adopt a “state passport system.”¹⁴ In this scenario, Congress would establish a national standard, or would defer rulemaking on an appropriate topic to an administrative agency, and failure by the states to implement an appropriate national standard would then result in federal preemption. Another version of the national passport approach would authorize FIO, for example, to evaluate state regulatory standards and identify best practices or national standards based on consensus of the states. If FIO surveys state regulatory practices, whether by mandate or choice, FIO could determine whether a satisfactory level of uniformity exists and promulgate that standard as a national target.

Another variant of federal standard-setting is the “federal tools” concept, whereby Congress enacts a regulatory standard and requires the states to develop, adopt, and implement regulation consistent with the standard. A “tools” bill typically requires state action within a limited period of time. In the absence of appropriate state action, or action by a defined number of states, then the federal law preempts the law in those states that have failed to act.

Federal standard-setting schemes can have shortcomings. First, if the legislation delegates a vague standard or objective to the states, it is unlikely to improve uniformity and efficiency as intended. Second, if the legislation contemplates an opt-in by the states, the probability that all states would opt-in may be small.

Thus, while bills to establish federal standards appear to promote incremental improvement on targeted areas, such legislation must specify standards, processes, and a deadline in order to minimize or eliminate the prospect of variance among the states. This experience points to a more general challenge for federal involvement as a standard-setter. Standards themselves may impose a degree of uniformity. However, application of those standards is equally important to imposing uniformity and consistency. Therefore, if federal involvement is to occur through standard-setting, it should be accompanied by mechanisms designed to enhance uniform implementation of the standards through proper, consistent enforcement.

Direct Federal Regulation

One manner of providing for uniform application of rules is to authorize the federal government itself to directly enforce federally-developed and adopted standards and rules. A number of proposals would have subjected much, if not the entirety, of insurance regulation to direct federal oversight. The underlying concept is that the federal government would act not just as standard-setter or rule-maker, but also as regulator and enforcer. Many view this as an essential objective of modernization due to the size and globalization of the insurance sector and its importance to the national economy. Others assert that the federal government need not regulate the entire insurance business, but only certain aspects of it.

For example, one approach would be to adopt federal regulation for those insurance firms that exceed thresholds of size, scale, and complexity, or those that have national or global business operations. Another approach, which has been a focus of prior proposals, is an optional federal charter, whereby those firms that opt for federal charters would be subject to federal regulation. Federal licensing and regulation of insurers, however, could be defined by the terms of eligibility. As proposed in the National Insurance Act of 2007 and the National Insurance Consumer Protection Act of 2009, the optional

¹⁴ The Financial Services Roundtable, Public Comment on *How to Modernize and Improve the System of Insurance Regulation in the United States*, December 15, 2011, available at www.regulations.gov.

How To Modernize And Improve The System Of Insurance Regulation In The United States

federal charter approach would leave to insurers the choice to adopt a federal charter and, therefore, to be regulated by the federal government or by the states.¹⁵ Yet another approach would be a combination of the first two, where, in general, firms would have an option to adopt a federal charter, but that federal regulation for certain large, globally active firms would be mandatory.

15 See pp. 16-17.

II. A BRIEF HISTORY OF THE REGULATION OF THE UNITED STATES INSURANCE INDUSTRY

Early Era of Insurance Regulation and the Limitation on Federal Authority

States first created corporate insurance companies in the late 18th century by enacting individual statutes or charters specific to each insurer. To supervise the activities of a growing industry, in 1851, New Hampshire appointed the first state insurance commissioner. A number of states followed soon thereafter. By 1871, each of the then-36 states had an insurance regulator.

There was evidence early that multistate activity by insurers could create tension with the state-based regulatory regimes. An early manifestation was the case of *Paul v. Virginia*, 75 U.S. 168 (1868). Several New York insurers had hired an agent to sell policies in Virginia, but because the insurers refused to deposit the licensing bond required by Virginia law, Virginia denied the agent a license. When the agent nevertheless sold policies, he was convicted for violating Virginia law. The New York insurers argued to the Supreme Court that the Virginia law was unconstitutional, in part as a violation of the Commerce Clause of the Constitution. The Court rejected the argument, and stated that the business of insurance was not a transaction of interstate commerce, thus placing insurance beyond the authority of the federal government to regulate. Accordingly, the ruling effectively established the states as regulators of the insurance sector.

The Court's decision did not eliminate multistate activity and, with multistate activity, there was recognition of the need for uniformity of rules in different states. The insurance industry and state regulators began to seek ways to promote coordination between states. In 1871, George W. Miller, New York's superintendent of insurance, invited the insurance commissioners from all 36 states to participate in a meeting to discuss insurance regulation. Representatives from 19 states attended the inaugural meeting of the association known today as the National Association of Insurance Commissioners (NAIC). The importance of uniformity was expressed at that meeting:

In a session “remarkable for its harmony,” the commissioners are now “fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all states—not reciprocal, but identical; not retaliatory, but uniform. That repeated consultation and future concert of action will eventuate in the removal of discriminating and oppressive statutes which now disgrace our codes, and that the companies and the public will both be largely benefited, we have no manner of doubt.”¹⁶

Box 1: The National Association of Insurance Commissioners (NAIC)

The NAIC is a voluntary organization that consists of the chief insurance regulatory officials of the 50 states, the District of Columbia, America Samoa, Guam, Puerto Rico, the U.S. Virgin Islands, and the Northern Mariana Islands. Originally formed in 1871, the NAIC reorganized in 1999 as a non-profit corporation under the general corporate laws of the State of Delaware and is a 501(c)(3) tax exempt organization.

16 Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, Florida State University Law Review Vol. 26, 625 at 632 (citing 1995 NAIC Annual Report 1 (1996) (quoting Baltimore Underwriter, June 1871)).

The NAIC itself is an association, not a regulator or government entity. Accordingly, public sector requirements do not govern the NAIC's administration, including employment, compensation, and procurement practices. As a private 501(c)(3) organization, the NAIC does not have authority to bind any state or state official to any law, policy, or practice, nor does it have the authority to speak for the United States. Similarly, the NAIC's 501(c)(3) status defines the extent to which it may engage in political and lobbying activities.

Purposes and Functions

The NAIC describes in its 2012 Annual Report the organization's function as a forum through which state regulators develop model laws and regulations:

"The NAIC provides its members with a national forum for discussing common issues and interests, as well as for working cooperatively on regulatory matters that transcend the boundaries of their own jurisdictions. Collectively, commissioners work to develop model legislation, rules, regulations and white papers to coordinate regulatory policy. The overriding objective is to protect consumers and help maintain the financial stability of the insurance marketplace."

Development of a model law proceeds in a number of stages, but must first be authorized by the Executive Committee, the managing committee of the NAIC. A number of qualifying criteria must be met before development of a model law is undertaken, including both: (1) the need for a national standard and uniformity among the states on the relevant policy issue and (2) the commitment among state regulators to support and implement a model law. Once a model law goes through the appropriate committees for review, its adoption by the NAIC occurs at a plenary session and requires a favorable vote of two-thirds of the NAIC members then attending. Model laws are generally not adopted uniformly and only become effective in a particular state if and when enacted by that state's legislature.

The NAIC also provides support services to assist states in implementing regulations. The level of state participation and use of each of these products and tools vary. Five such NAIC services are:

- Interstate Insurance Product Regulation Commission (IIPRC), which offers a centralized life insurance product approval process for 41 states;
- National Insurance Producer Registry (NIPR), which provides a national electronic database of licensed insurance producers;
- System for Electronic Rate and Form Filings (SERFF), which provides an electronic form and rate filing system for insurance products;
- State Based Systems, which offers on-line registration for producers; and,
- Online Premium Tax for Insurance, which allows for payment of premium taxes for multi-state placements.

Structure and Budget

The NAIC's 2013 approved budget includes total revenues of \$80.0 million, expenses of \$81.2 million, and a total unrestricted net asset balance of \$83.3 million. Revenue supporting the NAIC budget is derived from three primary sources: database filing fees paid by the insurance industry in connection with required statutory filings (\$26.8 million, or 33.5 percent of budgeted revenues); sales of publications and insurance data products (\$19.5 million, or 24.4 percent); and fees paid by the insurance industry for other services provided by the NAIC to satisfy state regulatory requirements (\$21.1 million, or 26.3 percent). The data that is included in NAIC products is taken from an insurance sector database that has been populated by data in reports filed with the NAIC by insurers pursuant to state regulatory requirements. State regulators also contribute \$2.3 million (2.9 percent) through membership assessments. For 2013, the NAIC budget authorizes

employment of up to 462 full-time equivalent positions across its three offices: the Executive Office in Washington, D.C.; the Capital Markets and Investments Office in New York, New York; and the Central Office in Kansas City, Missouri.

In addition to the Plenary and Executive Committees, the NAIC has seven major committees, each of which is responsible for particular areas of regulatory concern. A major committee may have task forces – as well as working groups and sub-working groups – that address specific issues. The seven major committees are:

- Life Insurance and Annuities (A) Committee
- Health and Managed Care (B) Committee
- Property and Casualty (C) Committee
- Market Regulation and Consumer Affairs (D) Committee
- Financial Condition (E) Committee
- Financial Regulation Standards and Accreditation (F) Committee
- International Insurance Relations (G) Committee

Early Calls for Federal Regulation of Insurance

The perceived state of the insurance industry in the early years of the 20th century sparked a debate about a potential federal role in insurance regulation. In the early 20th century, highly publicized reports and accusations of market manipulation and fraud associated with insurers prompted the New York State legislature, for example, to investigate the business practices of some of the largest life insurers. The results of the investigation documented abuses by life insurers, including stock market manipulation, falsified records to hide campaign contributions, and officers using company funds for personal use.¹⁷ Against this background, President Theodore Roosevelt spoke in favor of federal insurance regulation in his Annual Address to Congress in 1904. Discussing the strains on the state regulatory system through the growth of the insurance industry, he justified federal intervention by stating that the insurance business is “national and not local in its application,” and “involves a multitude of transactions among the people of the different States and between American companies and foreign governments.”¹⁸

In 1905, Senator John Dryden of New Jersey, founder and president of the Prudential Life Insurance Company, introduced a bill to implement President Roosevelt’s recommendation for the federal regulation of insurance by creating a “Bureau of Insurance” in the Department of Commerce and Labor, which was to be led by a “Comptroller of Insurance” appointed by the President to a four year term. He expanded the justification for federal regulation from combating manipulation and fraud to promoting uniformity and efficiency. Senator Dryden maintained, for example, that his bill would increase security to policyholders, decrease the cost of insurance, and result in “diminution of a vast amount of needless clerical labor to meet the requirements of some fifty different States and Territories and consequent decrease in expense rate.”¹⁹ He added, “Whatever may be said in favor of the national regulation of banks and railways applies with equal, if not greater, force in the case of this now universal institution, reaching as it does, all classes and affecting more or less all commercial interests.”²⁰ Thus, Senator Dryden offered many of the arguments that would be repeated in the following decades in favor of federal insurance regulation.

17 Kenneth J. Meier, *The Political Economy of Regulation: The case of insurance* (1988), pp. 57-8.

18 Theodore Roosevelt’s Annual Message to Congress for 1904; House Records HR 58A-K2; Records of the U.S. House of Representatives; Record Group 233; Center for Legislative Archives; National Archives.

19 *New York Times*, “Bill for Government Control of Insurance; to be introduced in the Senate by John F. Dryden,” Feb. 27, 1905, p. 5.

20 *Id.*

Congress did not pass Senator Dryden's proposed bill. Not everyone agreed that a federal solution was warranted. During the same period in which Senator Dryden introduced his legislation, for example, Louis Brandeis, then practicing law in Boston before becoming a Supreme Court Justice, expressed his belief that state regulation was preferable. At the time, he served as counsel to a New England policy-holders' committee that was concerned about the potential bankruptcy of Equitable Life Assurance of New York. After undertaking a study of the insurance industry, Brandeis expressed concerns about dishonest and inefficient management, the amount of capital that the large insurers controlled, and the inefficiency of state regulation. He nevertheless favored improving state regulation to replacing it with federal regulation, characterizing Senator's Dryden's proposal as a way to "free the companies from the careful scrutiny ... of the States."²¹

The Case of *South-Eastern Underwriters*, Federal Authority to Regulate Insurance, and the McCarran-Ferguson Act

In 1944, in a reversal of its previous position, the Supreme Court concluded that Congress had the power to regulate insurance transactions across state lines.²² In so concluding, it echoed the types of arguments made earlier by President Roosevelt and Senator Dryden, noting that insurance, "has become one of the largest and most important branches of commerce," and, "[p]erhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business."²³

The case that occasioned the Supreme Court's decision can be traced back to the San Francisco earthquake of 1906, which bankrupted many fire insurers. In the wake of these bankruptcies, a number of states allowed insurers to set premium rates collaboratively, which allowed insurers to avoid competition in pricing premiums. The rationale was that avoiding such competition would prevent a deterioration in insurers' financial condition and, consequently, possible insurer insolvencies. The insurance industry formed panels to collaboratively set rates in states where such rate setting was permitted.

Missouri did not allow collaborative rate setting. Certain fire insurers, however, were found by the United States to be bribing Missouri state officials to permit them to maintain rates in a manner that effectively amounted to rate setting. The United States filed suit alleging that the bribes and the rate setting constituted price fixing by a cartel in violation of the Sherman Antitrust Act. The case was brought against the South-Eastern Underwriters Association, the largest rate-setting bureau, and ultimately was presented to the Supreme Court in 1944. Cases such as *Paul* had raised the question whether a state had the authority to regulate and to tax specific activities of insurers based in other states. The anti-trust claim presented in the *South-Eastern Underwriters* case, however, raised the question whether the Commerce Clause of the Constitution granted Congress the power to regulate insurance transactions across state lines. The Court held that insurers were engaged in interstate commerce and concluded that, even though Congress had not specifically included a provision in the Sherman Act to apply to insurance, Congress had the power to include insurers within the scope of federal law.²⁴

21 Louis D. Brandeis, Counsel for the Protective Committee of Policy-Holders of the Equitable Life Assurance Society, "Life Insurance: The abuses and the remedies," Address delivered before the Commercial Club of Boston, 1905, available at <http://www.archive.org>.

22 *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944).

23 *Id.* at 540. The Court noted that the "business is not separated into 48 distinct territorial compartments which function in isolation from each other. Interrelationship, interdependence, and integration of activities in all the states in which they operate are practical aspects of the insurance companies' methods of doing business."

24 *Id.* at 552-553.

In 1945, in response to the *South-Eastern Underwriters* decision, Congress passed the McCarran-Ferguson Act²⁵ to clarify that state laws governing the business of insurance are not invalidated, impaired, or superseded by any federal law unless the federal law specifically relates to the business of insurance.²⁶ In the Act, Congress stated that, “the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several states.”

The Crises of Insurer Insolvencies, Congressional Reaction, and State Regulatory Responses

A wave of insolvencies among auto insurers in the 1960s rekindled the debate over the adequacy of state regulation and the inadequate level of uniformity in insurance regulation among the states. In the absence of guaranty funds, failure of these auto insurers left policyholders without adequate recourse against the assets of the insolvent insurer. The crisis attracted Congressional attention and, in 1966, prompted a proposal to create a federal guaranty system for insurers, modeled on federal bank deposit insurance.²⁷ A decade later, in 1976, Senator Edward Brooke introduced the Federal Insurance Act, which would have authorized the federal government to offer optional federal insurance charters, preempting state law, and would also have created a federal guaranty fund.²⁸ In a parallel effort a few years earlier, in 1969, state regulators, through the NAIC, developed a model guaranty fund act for property and liability insurance and, in 1970, a similar model for life and health insurance. Guaranty funds aimed to improve policyholder protection with an industry-funded, *ex post* claims payment system whereby consumers would receive some contractual benefit despite an insurer’s failure. Many states adopted versions of this model legislation.

After another series of insurer insolvencies, this time involving over 50 insurers in the 1980s and 1990s, including the largest life insurer in California at the time, Congress began a more extensive investigation into the adequacy of insurer solvency regulation. The House Committee on Energy and Commerce’s Subcommittee on Oversight and Investigations, chaired by Congressman John Dingell, issued a report in 1990 entitled *Failed Promises: Insurance Company Insolvencies*.²⁹ The report found that, “the present system for regulating the solvency of insurers is seriously deficient” due to rapid and unbridled expansion, underpricing, inadequate oversight, inadequate loss reserves, poor reinsurance transactions, and fraud.³⁰ In 1992, Chairman Dingell introduced a bill that, if enacted, would have instituted federal regulation of insurer solvency.³¹ In 1994, the same subcommittee issued a second report on insurer solvency regimes, entitled *Wishful Thinking: A World View of Insurance Solvency Regulation*.³² The report stated that, notwithstanding state regulatory efforts to address solvency reform, regulation re-

25 The McCarran–Ferguson Act, 15 U.S.C. §§ 1011-1015.

26 *Id.* at § 1012(b).

27 Sen. Thomas J. Dodd, “High-Risk Automobile Insurance Company Insolvencies,” *Congressional Record*, vol. 112, Feb. 17, 1966, pp. 3373-3374.

28 The Federal Insurance Act (S. 3884, 1976). A modified version of the bill was introduced as S.1710 in the 95th Congress.

29 U.S. House of Representatives, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, *Failed Promises: Insurance Company Insolvencies*, 101st Cong., 2nd Sess., Committee Print 101-P (Washington: GPO 1990).

30 *Id.* at III.

31 The Federal Insurance Solvency Act (H.R. 4900, 1992). The bill provided for a broad federal preemption of state insurance regulatory powers.

32 U.S. House of Representatives, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, *Wishful Thinking: A World View of Insurance Solvency Regulation*, 103rd Cong., 2nd Sess., Committee Print 103-R (Washington: GPO, 1994).

mained insufficient because state regulators lacked adequate national and international authority.³³ A minority report released by the subcommittee, however, disagreed and stated that it favored “strengthening, not dismantling, the current State regulatory system.”³⁴

In the aftermath of the *Failed Promises* and *Wishful Thinking* reports, in the 1990s, state regulators, through the NAIC, developed and adopted risk-based capital (RBC) formulae for life, property/casualty and health insurers. At the same time, states developed and adopted a self-accreditation program now known as the Financial Standards and Accreditation Program, a peer review process intended to improve consistency of financial regulation across the state system. Later, in 2001, after several years of development, state regulators codified statutory accounting principles (SAP) in an effort to further policyholder protection.

Recent Proposals for Federal Regulation of Insurance to Promote Uniformity

A number of proposals have been set forth more recently to enact federal legislation to address the inconsistency and absence of uniformity in the state-based system of insurance regulation. An important initial effort occurred in 1999, when Congress passed the GLBA.³⁵ Although GLBA allowed banks to affiliate with insurers through a federally regulated financial holding company, it preserved the states’ authorities to regulate insurance company affiliates. GLBA introduced the possibility of addressing the absence of uniformity in one key area of state regulation, however, when it included the requirement for the creation of NARAB to implement national insurance agent licensing requirements if a majority of the states and territories did not meet a 2002 deadline for reciprocity in producer licensing.³⁶ In 2002, the state regulators certified that 35 states and territories had satisfied the GLBA requirement, enough to constitute a majority and thereby avoiding the creation of NARAB.³⁷

GLBA was the beginning of a series of efforts over the ensuing decade to bring a federal regulatory presence to insurance. Between 2001 and 2006, the House Financial Services Committee held more than a dozen hearings at both the subcommittee and full committee levels on insurance matters at which witnesses discussed issues such as the increasing globalization of the insurance sector and inefficiencies attendant to the lack of uniformity in the state-based system of regulation. Members of Congress also offered legislative solutions. Congressman Michael Oxley and Congressman Richard Baker, for example, released a discussion draft called the State Modernization and Regulatory Transparency Act (SMART Act) in 2004, which proposed that states comply with uniform standards for licensing, market conduct regulation, reinsurance practices, and receivership rules. It also proposed expediting the process of introducing new insurance products to the market and shifting toward a system of market-based rates.³⁸

33 *Id.*

34 *Id.*, at 128.

35 Pub.L. 106-102, (1999).

36 *Id.* at § 321.

37 NAIC NARAB (EX) Working Group Report: Certification of States for Producer Licensing Reciprocity, Adopted Aug. 8, 2002. In 2008, in 2009, and again in 2011, Members introduced “NARAB II” bills to establish a national producer registry (H.R. 5611 (2008); H.R. 2554 (2009); H.R. 1112 (2011)). If enacted, the legislation would create NARAB as a national, nonprofit producer licensing corporation and would prohibit states from imposing any additional licensing requirements on non-resident producers who are NARAB members.

38 State Modernization and Regulatory Transparency Act (Discussion draft authored by Rep. Oxley, Chairman, House Fin. Serv. Comm. and Rep. Baker, Chairman, Capital Markets Subcomm.) (2004) available at http://www.aba.com/ABIA/Pages/Issue_RM.aspx.

Although the SMART Act would have required significant increases in the degree of uniformity, state regulators' authorities would have been preserved. Other proposals, however, have prescribed more extensive federal regulatory involvement to promote uniform national insurance regulation. For example, a number of bills have called for the creation of an optional federal charter, such as the National Insurance Act of 2007, co-sponsored in the Senate by Senators Tim Johnson and John Sununu, and in the House by Representatives Melissa Bean and Edward Royce.³⁹ This proposed legislation would have created an optional federal charter for property/casualty and life insurance.⁴⁰

The Executive Branch presented a similar proposal in a 2008 report by the Treasury entitled *Blueprint for a Modernized Financial Regulatory Structure*.⁴¹ Noting that the insurance regulatory system suffered from duplicative, inconsistent, and non-uniform regulation, the report proposed the creation of an optional federal insurance charter as an interim step toward a unified national chartering system. The *Blueprint* also included proposals for federal licensing for insurance producers and the creation of an Office of Insurance Oversight at Treasury.⁴² In April 2009, The National Insurance Consumer Protection Act was introduced in the House by Representatives Bean and Royce with the stated purpose of improving uniformity in insurance regulation.⁴³ The bill proposed a single, optional federal charter for the insurance industry, including insurers, reinsurers, and insurance producers.⁴⁴

In June 2009, the Treasury released *Financial Regulatory Reform: A New Foundation* that recommended the establishment of an Office of National Insurance “to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.”⁴⁵ In this policy statement, the Treasury articulated six principles by which to measure proposals for insurance regulatory reform:

1. Effective systemic risk regulation with respect to insurance.
2. Strong capital standards and appropriate match between capital allocation and liabilities for all insurance companies.
3. Meaningful and consistent consumer protection for insurance products and practices.
4. Increased national uniformity through either a federal charter or effective action by the states.
5. Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business.
6. Increased international coordination. Improvements to our system of insurance regulation should satisfy existing international frameworks, enhance the international competitiveness of the American insurance industry, and expand opportunities for the insurance industry to export its services.

39 S. 40 and H.R. 3200.

40 *Id.* These proposals are sometimes described as “dual charter” proposals.

41 Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, March, 31, 2008.

42 *Id.*

43 The National Insurance Consumer Protection Act (H.R. 1880) (April 2, 2009).

44 *Id.*

45 Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation*, June 2009, at 39.

The Financial Crisis

In 2007-2009, the United States faced the most severe financial crisis since the Great Depression. Like other parts of the financial sector, the insurance industry was affected by the crisis in several ways.

One of the most notable events of the crisis was the near-collapse of AIG, which threatened the stability of the entire U.S. financial system. Although AIG was principally an insurer, it also conducted other businesses, including a large amount of derivatives trading and securities lending. At the end of 2007, AIG's derivatives book was nearly \$2.65 trillion in outstanding notional amounts.⁴⁶ While some derivatives were used for hedging in the conduct of AIG's insurance business, its large credit default swap portfolio (\$562 billion at the end of 2007)⁴⁷ was located in a non-insurance, non-regulated affiliate, and these derivatives proved to be a major source of financial trouble for the firm and the U.S. financial system. Another major source of AIG's losses came from its large securities lending activities which were conducted through both insurance and non-insurance affiliates.

AIG owned a thrift and, therefore, AIG's holding company was regulated by the Office of Thrift Supervision (OTS). However, GLBA generally limited the authority of the OTS to supervise state-regulated insurance entities.

In the absence of an effective consolidated supervisor, AIG conducted its credit default swap (CDS) business largely outside of regulatory purview and engaged in securities lending activities that had not been previously approved. As it turned out, AIG did not have sufficient capital or liquidity to withstand the deterioration in the financial condition of its CDS and securities lending businesses that occurred during the financial crisis. (See Box 2.) The experience with AIG underscored the importance of consolidated supervision and appropriate prudential standards for certain types of nonbank financial institutions.

Box 2: AIG

Prior to the financial crisis AIG was regarded as the world's largest insurance firm with products in nearly every business line and entities domiciled throughout the United States and internationally. AIG's U.S.-based legal insurance entities were subject to state regulatory oversight. Due to the limits of state regulatory authority, the supervisory oversight of AIG's non-insurance operations was completely separate and distinct from oversight of its insurance businesses. While AIG's business ventures developed into complex non-insurance activities, the scope of state regulatory authority was demonstrably inadequate given AIG's size, scale, and complexity.

Credit Default Swaps

AIG conducted its CDS business through AIG Financial Products (AIG FP), which operated in Wilton, Connecticut; London, England; and Paris, France. Despite its locations in Europe, this subsidiary was not regulated by the EU because the EU recognized the U.S. Office of Thrift Supervision as the lead consolidated supervisor, meaning that the EU effectively deferred responsibility for supervision to the OTS. The OTS, however, rarely conducted examinations of AIG FP's activities, which included writing about \$562 billion of credit default swap protection. In part because of the fair value impairments associated with its CDS business, AIG experienced significant margin calls in 2007, was downgraded by the credit rating agencies in 2008, and ultimately, turned to the U.S. federal government to provide exceptional assistance.

⁴⁶ American International Group, Inc., Form 10-K, 2007.

⁴⁷ American International Group, Inc., Form 10-Q, Q2, 2008.

Securities Lending

AIG's insurance subsidiaries authorized a non-insurance affiliate, AIG Securities Lending Corporation (AIGSLC), to act on behalf of the subsidiaries to loan securities to other financial institutions in exchange for cash collateral. Although state regulators regulated only the AIG insurance entities and did not supervise AIGSLC, state regulators did approve the risk parameters that originally guided AIG's securities lending practices. Over time, however, AIG deviated from the approved parameters to grow a once-conservative business into a source of material risk to the insurers engaged in the securities lending activity. In 2005, AIG began investing the cash collateral it received through securities lending activities into residential mortgage backed securities (RMBS), which provided a return on investment higher than other securities.⁴⁸ By 2007, approximately 60 percent of AIG's invested securities lending collateral were in RMBS. As the mortgage crisis deepened, credit rating agencies downgraded RMBS from AAA status. The resulting drop in price and tightening liquidity in the underlying market for structured securities was a significant impediment to AIG selling its RMBS investments for cash in order to meet collateral calls. In the last two weeks of September 2008 alone, AIG's securities lending counterparties demanded that AIG return approximately \$24 billion in cash. This problem was exacerbated by the fact that the average maturity of the RMBS securities was materially longer than the average maturity of the securities loans, which often ranged from overnight to 60 days in maturity.

In 2007, state regulators identified the risks associated with AIG's shift from holding cash collateral to investing in RMBS. As of December 2007, securities lending assets and liabilities represented 7 percent and 8.5 percent, respectively, of AIG's consolidated balance sheet. Although numerous life insurers within AIG's corporate structure were involved in securities lending, the actual operations were centralized in AIGSLC.

During the financial crisis, the Federal Reserve and Treasury provided a total combined \$182 billion commitment to stabilize AIG, \$22.5 billion of which addressed liquidity issues in the securities lending program.

On December 11, 2012, Treasury sold its final shares of AIG common stock for additional proceeds of \$7.6 billion. Including the proceeds from that sale, the overall positive return on the Federal Reserve and Treasury's combined commitment to stabilize AIG during the financial crisis is \$22.7 billion. Since 2008, AIG's size as measured by assets has decreased 46 percent and the firm has re-focused on the core business of insurance.

The financial crisis also contributed to the failure of financial guaranty insurers, including both municipal bond and mortgage insurers. (See Box 5). Financial guaranty insurers provide protection from credit-related losses on debt products such as municipal bonds, mortgage and other asset-backed securities, and collateralized debt obligations. Bond issuers purchase this insurance, which effectively operates as a guaranty on the bonds, thereby providing better access to the market and reducing borrowing costs. The financial crisis forced several financial guaranty insurers into receivership or run-off. Only one of the firms existing pre-crisis continues to write new business today in the same form as prior to 2008, and that new business is limited to insuring municipal bonds. Exposure to mortgage-backed securities and other structured financial products led to the failure of some of the smaller bond insurers and to credit rating downgrades for the larger insurers, which impaired the ability of those insurers to generate new capital or write new business. These downgrades rippled through the municipal bond markets, causing significant difficulties for both investors and municipalities. State regulators respond-

48 Congressional Oversight Panel June Oversight Report: *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* (June 10, 2010).

ed by placing some of the financial guaranty insurers into run-off, which refers to a non-judicial orderly commercial wind down of the insolvent insurer.

Other parts of the insurance sector were also affected by the crisis. A number of insurers sought and obtained access to federal emergency liquidity assistance, largely to bolster capital for variable annuity products. In addition, state regulators provided direct aid to insurers during the crisis by permitting many insurers to deviate temporarily from NAIC-codified SAP.⁴⁹ (See Box 3).

Box 3: Assistance to the Insurance Industry during the Financial Crisis

During the financial crisis, a number of insurers received extraordinary support from governmental entities. This support was provided in the form of: (1) direct capital support by the federal government; (2) liquidity support through credit facilities established by the Federal Reserve; and (3) relief from SAP granted by state regulators.

Direct Capital Support

During the crisis, insurers that were bank or thrift holding companies were eligible to receive capital support from the Capital Purchase Program (CPP) as part of the Troubled Asset Relief Program. Several life insurers acquired regulated thrifts in order to qualify for capital investments available through CPP, although only two received CPP investments. Direct capital support was also provided separately to AIG through several complex, multi-step investments from the Treasury and the Federal Reserve.

Liquidity Support

Insurance groups were also beneficiaries of liquidity facilities, primarily from two temporary sources: (1) the Federal Reserve's Commercial Paper Funding Facility (CPFF); and (2) the Term Asset-Backed Auction Loan Facility (TALF) offered by regional Federal Reserve Banks.

The CPFF financed the purchase of unsecured and asset-backed commercial paper from eligible issuers through primary dealers. At the time, significant outflows from the money market sector severely disrupted the ability of commercial paper issuers to roll over short-term liabilities. The CPFF acted as a liquidity backstop for the commercial paper market. In at least 175 transactions from 2008 through 2009, firms engaged in the business of insurance made use of the CPFF.

The TALF was a credit facility created in December 2007 that allowed a depository institution to bid for a 28-84 day advance from its local Federal Reserve Bank at an interest rate determined by auction. By allowing the Federal Reserve to inject term funds through a broader range of counterparties and against a broader range of collateral than open market operations, TALF provided liquidity when the unsecured interbank markets were under stress.

Non-U.S. Government Support for Insurers Operating in the United States

In addition to support programs offered in the United States, insurers with substantial U.S. operations, but domiciled elsewhere, received home-country support. For example, one leading variable annuity writer that generates approximately two-thirds of its income from the United States received approximately \$3.7 billion from the Central Bank of its country of domicile. Another prominent variable annuity writer received more than \$13 billion from the Central Bank of its

49 NAIC, *Annual Statement Permitted and Prescribed Practices Reports* (http://www.naic.org/index_pps.htm).

home country and was forced to separate its banking and insurance activities. In addition, several other non-U.S. annuity writers have moved to sell or dispose of U.S. operations due, in part, to the additional capital demands of home country regulators caused by a U.S.-based variable annuity business.

Capital Relief through State Regulatory Permitted and Prescribed Practices

On November 11, 2008, the American Council of Life Insurers (ACLI) requested that state regulators “provide important near term relief from conservative reserve and risk-based capital standards” to help insurers manage the financial stress caused by the financial crisis. The ACLI’s proposal and recommendations for expedited change to existing regulatory provisions that governed statutory capital and surplus requirements were rejected by state regulators as a group on January 29, 2009. Nevertheless, throughout the year, state regulators permitted certain insurers to deviate from SAP equivalent to, or in excess of, what was sought by the ACLI. As a result, by allowing revised accounting practices (for example, for deferred tax assets) more favorable than previously allowed by statutory accounting rules and regulations, state regulators provided capital relief to some insurers at a critical time that, in some cases, had a substantial, positive effect on insurer RBC ratios.

According to NAIC annual statement data,⁵⁰ 61 life insurance groups reported positive effects on 2008 year-end surplus from state permitted or prescribed practices. The average benefit to surplus among those 61 groups was 9.64 percent. 15 of those groups benefitted by more than \$100 million, five of which benefitted by more than \$1 billion. 183 P/C insurance groups reported positive effects on 2008 year-end surplus from state permitted or prescribed practices. The average benefit to surplus among those 183 groups was 5.27 percent.

Financial Regulatory Reform

The Dodd-Frank Act introduced reforms to remedy the weaknesses in supervision of the financial system that were exposed through the financial crisis, including those that touched the insurance industry. For example, Title I of the Dodd-Frank Act established a new supervisory structure for the oversight of the U.S. financial system through the creation of the Council, which is charged with identifying and responding to threats to the stability of the U.S. financial system. The Council is authorized to determine that a nonbank financial company shall be supervised by the Federal Reserve and be subject to prudential standards if the Council determines that the nonbank financial company’s material financial distress or activities could pose a threat to the financial stability of the United States. The Federal Reserve must establish and enforce prudential standards for the largest bank holding companies and for nonbank financial companies supervised by the Federal Reserve.

The Dodd-Frank Act also addresses insurance more directly by creating FIO and by assigning to it an important financial stability role. FIO has the authority and responsibility to monitor all aspects of the insurance industry and to identify issues or regulatory gaps that could threaten the stability of the insurance industry or, more broadly, the U.S. financial system. FIO may also recommend to the Council that it designate an insurer as an entity subject to regulation as a nonbank financial company supervised by the Federal Reserve. FIO’s financial stability mission also includes playing a role in the context of Title II’s Orderly Liquidation Authority. Title II confers “key turning” responsibilities upon FIO, whereby the affirmative approval of the FIO Director and two-thirds of the Governors of the Federal Reserve are

50 SNL Financial (data extracted May 20, 2013) (comparing “Policyholder Surplus: State Prescribed & Permitted Practices” with “Policyholder Surplus: NAIC Statutory Accounting Principle” data elements at the “SNL Group” level for 2008 annual data).

required before the Secretary may make a determination on whether to seek the appointment of the FDIC as receiver of an insurance company.

Under the FIO Act, FIO's mission also extends to international matters, where FIO is responsible for coordinating federal efforts and developing federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the IAIS. Until the creation of FIO, a single federal entity had not been specifically designated to represent the United States in discussions about the global insurance regulatory framework and international regulatory standard-setting. FIO's current efforts on prudential aspects of international insurance matters, primarily coordinated through the IAIS, complement the reforms of the Dodd-Frank Act and include: (1) the identification of global systemically important insurers (G-SIIs) to be subject to heightened supervision and regulation; (2) the development of a common framework for the supervision of internationally active groups, including a quantitative capital standard; and (3) the integration of resolution measures into international standards applicable to insurers operating in multiple countries.

III. PRUDENTIAL OVERSIGHT

The Solvency Framework

In the context of insurance, “solvency” generally refers to the ability of the insurer to meet its obligations. Solvency regulation has been and continues to be primarily the responsibility of state regulators. It broadly consists of prudential rules (such as capital requirements and accounting standards, together with guidelines governing investment portfolios), protocols for regulatory intervention with troubled institutions (including insolvency proceedings and requirements for guaranty funds), and supervisory practices intended to promote and maintain the safety and soundness of insurers (including financial examination and analysis, company licensing, and collaboration with regulators from other states and international jurisdictions). Primary financial oversight of any given insurer is performed by the state in which the company is domiciled, *i.e.*, typically where it was formed and maintains its corporate license to operate. Other states generally defer to the regulatory authority of the insurer’s domestic state with respect to prudential supervision.⁵¹

Before the financial crisis, increasing globalization and complexity of the business of insurance had prompted the international regulatory community to reexamine the adequacy of prudential oversight of insurers and the consistency of cross-jurisdictional and cross-sectoral regulatory treatment. The importance of that review has only been underscored by the financial crisis. Currently, domestic and international regulatory discussions around solvency regulation are primarily focused on prudential standards, enterprise risk management, and group (*i.e.*, consolidated) supervision. FIO has authorities that include monitoring all aspects of the industry and the identification of issues or gaps in regulation that could have financial stability consequences, and representing the U.S. government in prudential aspects of international insurance matters. The dual developments of the financial crisis and the unprecedented internationalization of the insurance market have led to increased emphasis on all aspects of solvency oversight, both at the state and federal levels. In addition, international standard-setting activities have grown in importance and focus.

More specifically, the IAIS is the forum through which insurance supervisors and authorities from more than 140 countries, including U.S. state regulators, convene to develop international insurance supervisory standards and best practices. The IAIS does not prescribe a particular approach or structure with which a country must satisfy an international standard.

The Dodd-Frank Act vests FIO with authority to:

coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (or a successor entity) and assisting the Secretary in negotiating covered agreements[.]⁵²

FIO currently represents the United States on the IAIS Executive and Financial Stability Committees, and is involved with the Macro-Prudential Surveillance Subcommittee, along with other subcommittees. FIO’s Director also serves as Chair of the IAIS Technical Committee, which leads the development of substantive, technical standards, including the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame).

51 State regulators developed the Financial Regulation Standards Accreditation Program (*see* p. 29) between 1988 and 1990 in the midst of a series of large insolvencies and congressional inquiry into those insolvencies that culminated in the *Failed Promises* report.

52 31 U.S.C. § 313(c)(1)(E).

In its role as representative of the United States, FIO consults with state regulators, relevant federal agencies, consumers, insurers, and other stakeholders and technical experts. FIO's current substantive priorities in this capacity are: (1) developing and field testing ComFrame so that it serves supervisors' interests and reflects the realities of insurance industry practices; (2) refining a methodology and process to identify G-SIIs; (3) establishing enhanced supervisory measures to be applied to a G-SII, including cross-border resolution practices; and (4) enhancing insurance group supervision in light of recent Financial Stability Board (FSB) recommendations. While FIO is not a functional regulator, these international prudential matters fall within the ambit of the authority to develop federal policy on prudential aspects of international insurance matters. In addition, FIO's authority to monitor all aspects of the insurance industry, including its regulation, bring these matters of financial stability and the standards applicable to internationally active insurers directly within FIO's area of focus.

On October 16, 2013, the IAIS released a third version of a draft consultation paper that outlines ComFrame. ComFrame is designed to establish a comprehensive framework for supervisors to: (1) address activities and risks at the insurance group level; (2) develop principles for better global supervisory cooperation; and (3) foster global convergence of regulatory and supervisory measures and approaches. The ComFrame concepts, as presently drafted, are likely subject to revision and refinement through the results of the important field testing phase, which is in its early stages and will study the impact of ComFrame's qualitative and quantitative requirements. Through the development of common supervisory approaches, implementation of ComFrame should reduce the compliance and reporting burden on the increasing number of insurers operating in multiple international jurisdictions, and increase the shared confidence of global supervisors. In addition, ComFrame seeks to further understanding of group structures through risk analysis and transparency. Improved consistency of supervisory approaches to solvency oversight would promote more effective and efficient supervision of groups, build trust among the international supervisory community, and foster markets that allow for the participation of U.S.-based insurers.⁵³

In 2010, the FSB instructed the IAIS to develop a methodology to identify G-SIIs and the enhanced prudential measures to which designated firms would be subjected. The IAIS established the Financial Stability Committee (FSC), in which FIO has participated since July 2011 and been actively engaged since April 2012. FIO's FSC priorities have been to work with national and international colleagues to ensure the rigor and quality of the IAIS methodology, as well as to align the IAIS process with the Council's three-stage process for determining whether a nonbank financial company should be designated for supervision by the Federal Reserve.

Insurers, in contrast to banks, are not currently subject to uniform capital requirements at the global level. On July 18, 2013, the FSB issued mandates to change that, directing the IAIS to make tangible progress in the following areas:

- As a foundation for Higher Loss Absorbency (HLA) requirements (*i.e.* higher capital requirements) for G-SIIs, the IAIS will develop a Straightforward Backstop Capital Requirement (SBCR) to apply to all group activities, including non-insurance subsidiaries, to be finalized by the end of 2014.
- Building on the SBCR, and following public consultation, the IAIS will, by the end of 2015, develop implementation details for HLA requirements. These will apply starting from January 2019 to those G-SIIs identified in November 2017, using the IAIS methodology.
- The IAIS will develop, and the FSB will review, a work plan to develop a comprehensive, group-wide supervisory and regulatory framework for Internationally Active Insurance Groups (IAIGs), including a quantitative capital standard (QCS). The timeline for the finalization of the framework will be agreed by the FSB by the end of 2013.

⁵³ See IAISweb.org for more details.

On the same day the FSB issued these mandates, it also announced that, in consultation with the IAIS and national authorities, it had identified an initial list of G-SIIs. The population of IAIGs—approximately 50-60 firms from around the world—would include all nine G-SIIs.

The IAIS has been considering alternatives for an SBCR. These proposals will be released for a 60-day public consultation beginning in December 2013. Through 2014, the IAIS will finalize an initial version of the SBCR and alternative approaches for the application of HLA requirements to the G-SIIs. Even once finalized, the SBCR will be subject to testing and refinement in the years leading to 2019. Whether the SBCR serves as a basis for HLA, whether the QCS will build on the SBCR, or whether the QCS will serve as the basis for HLA, remain open questions.

The IAIS released a revised draft of the ComFrame concept paper for a 60-day public consultation on October 16, 2013. This version of ComFrame includes a capital adequacy assessment process that would subject an insurance group to a series of plausible and adverse scenarios. At the same time, ComFrame's QCS will be developed in concept by the end of 2016 and, thereafter, will be tested for two years before being finalized in late 2018.

Development of international insurance capital standards remains a daunting and unprecedented challenge. Nevertheless, driven by the fast-paced internationalization of insurance markets, IAIS members appear committed to achieving the stated objectives. Of necessity, the SBCR will be simpler and less granular than the QCS, although development of both will be guided by the boundaries of time, resource and achievability.

Another significant development in solvency oversight has been the EU's 2009 adoption of a regulatory framework known as Solvency II. Solvency II will soon be adopted by the European Parliament as part of an omnibus legislative package, with a scheduled implementation date of 2016. Notably, despite the previous delays with adoption in the EU, components of Solvency II have been adopted in other countries, including China and Mexico.

Broadly structured around the three pillars of capital, supervision, and disclosure, Solvency II would require adherence to RBC requirements at both the individual regulated entity and group levels, whether pursuant to a standardized formula or based on the insurer's own internal models subject to supervisory review. (See Box 4). As originally formulated, Solvency II would have been particularly consequential for the U.S. insurance sector because of its requirement for unilateral assessments of insurance regulation in other jurisdictions (including the United States) and because it would impose solvency requirements on insurers doing business in the EU to the extent the home jurisdiction's requirements are deemed to be unsatisfactory in comparison to Solvency II. Through the EU-U.S. Insurance Project (see Box 4), the EU and the United States have committed to a collaborative work plan that will enhance understanding and cooperation and, where appropriate, promote greater consistency between the two jurisdictions. Thus, the orientation of the discussion has been altered by virtue of the EU-U.S. Insurance Project which will lead, where appropriate, to the increased convergence and compatibility of the two insurance regulatory regimes.

Finally, in the United States, in December 2012, state regulators released a Solvency Modernization Initiative (SMI) Roadmap, which they describe as a critical self-examination designed to update the states' approach to solvency oversight. Among the areas reviewed are capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. The SMI Roadmap also reports state regulators completed adoption of the Risk Management and Own Risk Solvency Assessment (ORSA) Model Act, which comprises enterprise risk management requirements and standards for insurers, together with the *ORSA Guidance Manual*. The SMI Roadmap also notes that state regulators adopted the NAIC Insurance Holding Company System Regulatory Act

to provide state regulators with authority, albeit indirect, over non-insurance entities in an insurance group. State regulators also continue to develop task forces and working groups to address, or to discuss, substantive matters such as group supervision, reinsurance captives, and monoline insurers. Most recently, in March 2013, the NAIC released a white paper on the merits of state regulation that reports on the states' efforts to address known challenges for the state-based system.

Box 4: Europe's Insurance Regulatory Regime – Solvency II

Overview of the Three Pillars

In the EU, the European Parliament and European Commission (EC), and the European Insurance and Occupational Pensions Authority (EIOPA) are modernizing the EU's insurance regulatory regime under the Solvency II Framework Directive. The directive, introduced in 2007 and enacted in 2009, will be the culmination of work begun in the early 1990s to update existing solvency standards. Despite a few setbacks and modifications, Solvency II's implementation date is now set for 2016.

Solvency II establishes a risk-based approach to insurer capital requirements that relies on three pillars, modeled after the three-pillared Basel II framework for banks. The pillars of Solvency II consist of: (1) substantive and quantitative RBC requirements; (2) system of governance; and (3) market discipline through disclosures to supervisors and the public.

Pillar I sets target capital levels for a given insurer based upon either a standard formula or, subject to regulatory approval, an insurer's internal models. The standard formula is a stressed Value at Risk (VaR) calculation that looks to capture the full set of risks that an insurer faces, including underwriting risk (life, nonlife, health), market risk, counterparty credit risk and operational risk. Pillar I targets capital requirements for insurers at a level that, based on the VaR analysis, would allow for only a 0.5 percent chance of failure over a one-year time horizon. These capital and related reserve requirements were the subject of an EU impact study, particularly as applied to annuity-like products with long-term guaranty features.

Solvency II would also establish a comprehensive supervisory regime for insurance groups that includes a single group supervisor and consolidated capital requirements for insurance groups. Despite the existence of issues that have delayed full implementation, Solvency II remains the aspirational supervisory regime for the EU. Moreover, many aspects of Solvency II have become international standards for insurance supervisors in developing economies and in mature economies seeking to modernize an existing supervisory regime. For example, capital assessment elements of Solvency II are important elements in the revised supervisory regimes in Mexico, China and South Africa. Furthermore, EIOPA and the World Bank have signed an operational Memorandum of Understanding to cooperate on developing the global insurance sector, which includes promoting a risk-based regulatory and supervisory framework in insurance, as well as the identification of systemic risk and the promotion of consumer protection.

Pillar II, the system of governance, imposes requirements on insurers and groups with regard to risk management and internal control systems, as well as with regard to key functions which, at a minimum, must include the risk management, compliance, audit and actuarial functions. Pillar III sets forth requirements for information to be reported to supervisors and for information to be publicly disclosed so as to enable assessments of an insurer's overall financial condition in addition to market trends and risks.

Regulatory Regime Equivalence

Solvency II includes a provision by which the EC determines whether non-EU regulatory systems provide a similar level of protection to policyholders as would the Solvency II regime, and are therefore “equivalent” to Solvency II. The equivalence assessment would be based on three criteria, two of which relate to group supervision and one of which relates to reinsurance supervision. Insurers in “equivalent” jurisdictions would be able to access the EU market, and EU-based insurers would be able to access non-EU markets, without the imposition of additional capital requirements or restrictions. Insurers in non-equivalent jurisdictions would need to undertake structural changes to “ring-fence” European assets from non-EU assets, including, for example, the creation of separate holding companies within EU jurisdictions.

EU-U.S. Insurance Project

For several years, uncertainty over how the EU “equivalence” assessment would affect U.S. companies had a negative impact on firms operating in the two jurisdictions. To address the issue, in January 2012, FIO hosted representatives of the EC, EIOPA, and state regulators to facilitate a dialogue to improve understanding and cooperation between the EU and U.S. insurance regulatory regimes and, where appropriate, to foster convergence. To this end, the parties developed a work plan for 2012, which consisted of identifying and comparing the significant aspects of each jurisdiction’s regulatory scheme. On December 21, 2012, after executing the year’s work plan, all parties agreed upon objectives for future work to improve convergence and compatibility. The objectives are to:

- 1) Promote information sharing between EU and U.S. supervisors under conditions of professional secrecy by removing barriers to the exchange of information while seeking to uphold critical confidentiality standards.
- 2) Establish a robust regime for group supervision, under which there is:
 - a) A clear designation of tasks, responsibilities and authority among supervisors, including a single group/lead supervisor;
 - b) A holistic approach to determining the solvency and financial condition of the group that is consistent with insurance business practices, that avoids double-counting of regulatory capital and that monitors risk concentrations, considers all entities belonging to the group, and is complementary to solo/legal entity supervision;
 - c) Greater cooperation and coordination among supervisory authorities within colleges; and,
 - d) Efficient enforcement measures at the group and/or solo level that allow for effective supervision of groups.
- 3) Further develop an approach to valuation that more accurately reflects the risk profile of companies, is sufficiently sensitive to changes in that risk profile, and has capital requirements that are fully risk-based, based on a clear and transparent calibration and that cover similar categories and subcategories of risk to which companies are exposed.
- 4) Work to achieve a consistent approach within each jurisdiction and examine the further reduction and possible removal of collateral requirements in both jurisdictions in order to ensure a

risk-based determination for all reinsurers in relation to credit for reinsurance.

- 5) Pursue greater coordination in relation to the monitoring of the solvency and financial condition of solo entities and groups through the analysis of supervisory reporting. The exchange of information is facilitated by the joint exchange of best practices for analysis and an evolution towards a greater consistency of reporting.
- 6) Ensure the consistent application of prudential requirements and commitment to supervisory best practices through different peer review processes that ensure an independent view of the jurisdiction being examined.
- 7) Ensure consistency and effectiveness in the supervision of solo entities and groups.

Each of the foregoing objectives is supported by a number of initiatives to be pursued over a five-year period. A copy of the “EU-U.S. Dialogue Project Technical Committee Reports Comparing Certain Aspects of the Insurance Supervisory and Regulatory Regimes in the EU and the United States,” and of the “EU-U.S. Dialogue Project: The Way Forward,” can be found on the FIO web site. While marking a significant step towards improving cross-border oversight between the EU and the United States, the Project also facilitates a level of convergence that will benefit industry, consumer, and supervisory interests. In addition, the objectives for each of the seven areas are fundamental to the modernization and improvement of the U.S. system of insurance regulation. Given the national importance of the agreed-upon objectives of this project, failure of the U.S. state regulatory system to pursue adoption of these objectives could warrant greater federal involvement.

Capital Standards

The Current Framework and the Challenge of Non-Uniformity

Recommendations: (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.

Insurers, like other financial institutions such as banks, are subject to capital requirements. Capital requirements for insurers, however, are not determined in the same manner as are those for banks. This in part reflects the differences in banks’ and insurers’ business models, risk profiles and balance sheets. Banks generally lever balance sheets with deposits and debt (some short-term) and use those funds to underwrite loans and to engage in capital markets activities. Assets that banks finance are designed to earn returns from the spread between the interest earned on the long-term assets and the interest paid on short term liabilities. Banks face both credit risk and interest rate risk on those assets and liquidity risk on the ability to fund short-term operations and liabilities. The bank capital regime is therefore designed largely to address credit and liquidity risk, although banks with trading activities also are subject to market risk capital regulation.

Insurers, by contrast, typically do not carry much debt either in unsecured debt at the holding company level or in short-term wholesale funded debt at the entity level. Rather, insurers are primarily funded through investment income and policyholders’ premiums, the latter of which are paid periodically and in advance in exchange for insurance coverage that pays out when an insured event occurs. Insurers typically invest premiums received in liquid assets (frequently bonds) that typically match the

duration of liabilities. Since insurers typically have less leverage than banks and prefund insurance liabilities by investing premium income, insurers generally are not subject to the kind of liquidity risk that banks face. Insurers are subject primarily to underwriting risk and market risk (including both interest rate risk and credit risk).

State regulation, which directly regulates only insurance entities, requires insurers to satisfy RBC requirements. RBC does not set a capital target for an insurer but, rather, sets a baseline capital level such that, in the event an insurer approaches that baseline level, a state regulator may take corrective action to conserve or improve the insurer's financial condition. RBC requirements are grounded in a basic risk-based methodology that takes four categories of risk into account. Briefly, these risks are: (1) asset risk, which covers market and credit risks on balance sheet assets, including bonds, equities and other financial assets, as well as reinsurance receivables and investments in subsidiaries; (2) insurance risk, which covers risks related to the underwriting and pricing of policies and contracts, as well as risks related to the adequacy of claims reserves; (3) interest rate risk, which covers potential losses due to interest rate changes and asset/liability mismatch; and (4) business risk, which covers guaranty fund assessments and general business risks, such as litigation.

NAIC Financial Regulation Standards Accreditation Program

States have sought to establish generally consistent solvency oversight approaches across jurisdictions through the NAIC Financial Regulation Standards Accreditation Program (Accreditation Program). Following the wave of insurer insolvencies in the 1980s, the Accreditation Program was developed as a response to Congressional inquiries into the regulation of insurers. The Accreditation Program evaluates member states for substantial compliance with NAIC-established solvency oversight standards and practices. Accreditation standards are minimum standards against which states are assessed on not more than a five year cycle.

To be accredited, a state must have in force laws that are substantially similar to the significant elements that have been identified as the key provisions in each of the relevant NAIC model laws or regulations. If a state fails to meet the accreditation standards and loses its accreditation, then the work of that state regulator in maintaining and enforcing insurer solvency standards for its domestic industry will not receive deference from other states' regulators. Although several states have been subjected to tentative accreditation pending improvement, no state has ever lost its accreditation. All states are now accredited, with the State of New York having been accredited most recently in 2009.

Notwithstanding the foregoing efforts to establish consistency in capital regulation, significant elements of non-uniformity remain. First, for example, even though RBC standards have been adopted by all states, those standards are not applied to all insurers. Some states allow certain classes of insurers not to comply with RBC requirements. For example, fraternal benefit societies operating as life insurers are treated differently for RBC purposes and only 14 states have adopted the applicable model law.

Second, as another example, monoline insurers (*e.g.*, mortgage insurers and financial guaranty insurers) are not subject to RBC requirements; instead, these entities have been subject to different capital ratio requirements that are enforced differently from state-to-state. Up to and through the crisis, state regulators granted waivers from adherence to capital ratio requirements in order to allow mortgage insurers to continue operating. These developments are particularly noteworthy given the subsequent history of insolvency with much of the financial guaranty business and the challenges encountered by mortgage insurers, including insolvency. (*See* Box 5).

Box 5: Credit Rating Agencies, Financial Guaranty Insurance, and the Financial Crisis

Credit rating agencies (CRAs) have played a twofold role in the insurance industry: (1) providing views of an insurer's solvency to policyholders and lenders; and (2) rating financial instruments in an insurer's investment portfolio. Both roles significantly inform the amount of capital that insurers hold. Some state that the role of CRAs in assessing the targeted capital levels that insurers and groups should hold based on risk profiles is as or more important than that of the state regulators which, through RBC, focuses on a quantifiable basis on the amount of capital necessary for individual insurers (but not groups) to avoid regulatory intervention.

The financial crisis highlighted pervasive problems with the CRA business model and practices, such as conflicts of interest, inadequate controls, and unreliable ratings methodologies. The ratings assigned by CRAs on many assets turned out to be higher than warranted. Belated downgrades of assets caused significant market disruption.

One example of CRAs' failure was the incorrect assessment of the health of financial guaranty insurers. Financial guaranty insurers are organized as "monoline" insurers because state insurance regulations generally prohibit these firms from writing other types of insurance. The financial crisis showed that the monoline nature of the business, together with the performance of the assets underlying the guaranties, contributed to insolvencies of financial guaranty insurers.

For many years, the assets guaranteed by most financial guaranty insurers, such as mortgages and municipal bonds, were generally considered low-risk because of historically low default rates. As a result, financial guarantors held low levels of capital with the consent of the regulators. On the same rationale, financial guarantors received top ratings from CRAs notwithstanding low capital levels and the eventual movement from the core business model to provide guaranties on assets such as riskier structured products, including collateralized debt obligations consisting of mortgage-backed securities.

During the crisis, as the number of defaults on the underlying assets increased, the mortgage-backed securities were downgraded and dropped in value. Financial guaranty insurers were forced to recognize losses which eroded already thin layers of capital. The loss recognition in turn caused CRAs to downgrade these insurers, thereby subjecting the insurers to a vicious cycle of collateral calls and additional market pressure, which further accelerated loss recognition. The losses for financial guaranty insurers contributed to temporary dislocation in the municipal bond market, and limited the access of municipal issuers to the market. Since the crisis, much of the municipal bond market has moved forward without the wrap of a financial guaranty.

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC) to adopt rules to govern CRAs on conflicts of interest, ratings performance and methodology transparency, strengthening internal controls policies and procedures, improving governance, and training and competency standards for credit analysts. In addition, Section 939A of the Dodd-Frank Act requires federal agencies to remove regulatory references to credit ratings and to replace those references with alternative measures of creditworthiness and reliance.

State regulators have sought to decrease the influence of credit ratings both by expanding the role of the NAIC's Securities Valuation Office (SVO) and by retaining contractors to evaluate the quality of collateral underlying mortgage-backed securities. The SVO, which has historically provided credit ratings for insurers and supervisors for non-rated securities, now also offers high level guidance and insights for both insurers and supervisors. With respect to mortgage-backed securities, the NAIC engaged contractors, at industry expense, to support the move away from rigid dependence on credit ratings. These contractors are responsible for reviewing the loss probabilities in mortgage-backed securities based on the underlying collateral and aiding in the determination of the NAIC designations that translate into RBC factors.

Third, RBC standards are not necessarily applied uniformly. The lack of uniformity occurs largely because of a range of discretionary decisions by state regulators that can affect the reported or actual amount of an insurer's capital. These discretionary decisions can occur in a number of areas, but some of the more important decisions that affect solvency oversight involve decisions regarding reinsurance captives and permitting deviations from standard accounting practices. Although supervisory discretion may be necessary for some regulatory purposes, a principal concern with extensive and inconsistent use of such discretion is that it may effectively exempt an insurer from abiding by capital requirements, thereby undermining the comparability of the RBC framework across different jurisdictions. Such variability has the potential to create safety and soundness concerns. Moreover, such inconsistent discretionary decisions create competitive imbalances that disadvantage insurers domiciled in one state solely because that regulator's discretion may be more circumspect than that of the lead state regulator of a competitor.

It is important for accounting and capital standards, and discretionary variances from those standards, to be governed by uniform rules. Under the current system of state regulation, consistency can occur only by uniform adoption and implementation of such standards and rules. As noted, however, the regulatory system has not resulted in consistent implementation of solvency oversight, notwithstanding coordination efforts through the NAIC, because regulators have interpreted and enforced even similar standards differently.

Two reforms could assist the coordination efforts and further improve uniformity and consistency. First, variations resulting from discretionary practices can be reduced if state regulators develop and implement a process whereby before implementing a discretionary practice involving important solvency oversight matters, the domestic state regulator notifies and also obtains the consent of regulators from other states in which the subject insurer operates. In the case of insurers operating in multiple states, such an approach would require, at a minimum, the concurrence of insurance regulators from multiple states prior to permitted deviation from significant solvency standards. For insurance groups that are subject to supervisory college oversight, consent of other regulators could be obtained through the ongoing activities of the college.

Second, the credibility and effectiveness of the Accreditation Program could be bolstered if it becomes also subject to independent, third party review. Currently, only state regulators, NAIC staff, and NAIC contractors are charged with evaluating states' compliance with the Accreditation Program. States often consult with the NAIC's legal staff when considering adoption of model laws and regulations, yet it is the NAIC's legal staff that is solely responsible for assessing compliance of states with adoption of the key elements of model laws and regulations. To improve the reliability of this peer review structure, an additional independent review and audit layer would provide a helpful perspective on the uniform adoption and implementation of capital rules and other standards. This independent review will also help to maintain the incentive for accreditation reviews to be conducted with appropriate and objective rigor.

Mortgage Insurance

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

Like financial guarantors, private mortgage insurers are monoline companies that experienced devastating losses during the financial crisis. A business predominantly focused on providing credit enhancement to mortgages guaranteed by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, mortgage insurers migrated from the core business of insuring conventional, well-underwritten mortgage loans to providing insurance on pools of Alt-A and subprime mortgages in the years leading up to the financial crisis. The dramatic decline in housing prices and the impact of the change in underwriting practices required mortgage insurers to draw down capital and reserves to pay

claims resulting in the failure of three out of the eight mortgage insurers in the United States. Historically high levels of claim denials, including policy rescissions, helped put taxpayers at risk.

Regulatory oversight of mortgage insurance varies state by state. Though mortgage insurance coverage is provided nationally, only 16 states impose specific requirements on private mortgage insurers. Of these requirements, two govern the solvency regime and, therefore, are of particular significance: (1) a limit on total liability, net of reinsurance, for all policies of 25 times the sum of capital, surplus, and contingency reserves, (known as a 25:1 risk-to-capital ratio); and (2) a requirement of annual contributions to a contingency reserve equal to 50 percent of the mortgage insurer's earned premium. In addition to the states, the GSEs (and through conservatorship, the Federal Housing Finance Agency) establish uniform standards and eligibility requirements that in some cases are more stringent than those required by state regulators. As the financial crisis unfolded, mortgage insurers no longer met state or contractual capital requirements. State regulators granted waivers in order to allow mortgage insurers to continue to write new business while the GSEs loosened other standards that were applicable to mortgage insurers.

The private mortgage insurance sector is interconnected with other aspects of the federal housing finance system and, therefore, is an issue of significant national interest. As the United States continues to recover from the financial crisis and works to reform aspects of the housing finance system, private mortgage insurance may be an important component of any reform package as an alternative way to place private capital in front of any government or taxpayer risk. Robust national solvency and business practice standards, with uniform implementation, for mortgage insurers would help foster greater confidence in the solvency and performance of housing finance. To achieve this objective, it is necessary to establish federal oversight of federally developed standards applicable to mortgage insurance.

Captives and the Impact on Capital in the Life Insurance Industry

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

Captive insurance programs, in the conventional meaning, typically are entities (usually corporate affiliates set up by a parent company) that provide a self-funded insurance-like product for a single non-insurance business. Captives include a diverse set of entities and are most often established to meet the unique needs of the owner. For example, a large manufacturing firm may establish a captive to cover property damage to its facilities around the country.

However, captives also have developed as a tool for insurers to transfer risk within the affiliated insurance group. A reinsurance captive, sometimes referred to as a special purpose vehicle, or SPV, allows an insurer to transfer risk to an affiliated entity, thereby reducing reserve obligations and freeing the underlying insurer's capital to be used for other purposes. However, reinsurance captives are not subject to the same solvency oversight as a traditional commercial insurer or reinsurer. Thus, reinsurance captive programs can be mechanisms by which insurers decrease capital and reserves at the insurance-entity level through intra-group reinsurance arrangements while also reducing overall regulatory scrutiny across the group.

Over the past 30 years, the use of captives has grown from less than 1,000 captives in 1980 to over 5,000 operating worldwide today.⁵⁴ In particular, U.S. commercial life insurers' use of reinsurance captives to transfer insurance risk has grown, perhaps due to reserve requirements for some life insurance and annuity products. In the United States, almost 30 states, the District of Columbia and the U.S. Virgin

54 Marsh, Next Generation Captives – Optimising Opportunities, 2008; A.M. Best Captive Center.

Islands serve as domiciles for reinsurance captives.⁵⁵ Indeed, states are aggressively competing to be domestic regulators for reinsurance captives.

There are two basic concerns with reinsurance captives that are increasingly prevalent in the life insurance business. The first is that reinsurance captives allow an insurer to receive credit against its reserve and capital requirements by transferring risk to the captive even though the captive is not bound by rigorous or consistent capital rules across the states. Reinsurance captives can be established with a small percentage of the capital required to establish a commercial insurance license in the same state. In particular, the standards that govern the quality of capital that reinsurance captives must hold are not sufficiently robust. For example, some state laws currently allow intra-company letters of credit, parental guaranties, or intra-company guaranties to constitute capital for captives. These instruments may not be sufficiently loss-absorbing if a significant adverse event were to occur. In many cases, a significant adverse event would cause a captive to fail and spread losses retained within the holding company or to another affiliate within the group, thereby accentuating group risk.

If an insurer is to receive credit against a capital or reserve requirement because of risk transferred to an insurance captive, the rules governing the quality and quantum of assets offered in support of the captive should be uniform across states and sufficiently robust and transparent in order to prevent arbitrage by insurers. The matter is one that must be assessed within the rubric of the capital adequacy of an insurance group as a whole. Under the current state-based capital adequacy regime, group capital assessments rely on CRA ratings or on a firm-produced ORSA to evaluate a group's capital position and the strength of intra-group guarantees. Neither of these measures of group capital adequacy, however, is a substitute for group capital standards that are established and supervised by regulators.

Second, there is a lack of transparency for captive oversight from state-to-state. While transparency to investors and the public is important, transparency to regulators is particularly critical and absent. Unlike the case of traditional insurers for which financial statements are made publicly available on the NAIC's website or the websites of the domestic state and the company itself, the financial statements of captives are kept confidential between the captive manager and the domestic state. Due to the limits of state regulatory authority, this concern is especially critical when a state regulator must rely on information from another state in which a reinsurance captive is domiciled.

In response to these issues and to the increased use of reinsurance captives, the NAIC commenced a review of state approaches to captives in October 2011. The NAIC received comments on a draft white paper on regulation of reinsurance captives, released on November 29, 2012, which offered five recommendations addressing accounting, confidentiality and reinsurance regulatory matters. The NAIC then issued a revision of the white paper on June 6, 2013. While this paper showed the regulator dialogue was continuing, it notes the lack of agreement among the states on issues of transparency and confidentiality, on whether captives should be assigned a company code and name and included in the regulators' company database, and on how to address inconsistencies between the current approach to reinsurance captives and the more general laws governing credit for reinsurance (where the reinsurer is a third party company, as opposed to an affiliate within the same group). The comments illustrate that several states seek greater regulatory scrutiny and uniformity in captive oversight, while others remain committed to the *status quo*. Still other states are interested in reducing oversight fees and premium taxes for reinsurance captives, possibly to allow jurisdictions to attract more reinsurance captive enterprises for economic development purposes.

On June 12, 2013, the New York Department of Financial Services (NYDFS) issued a report that details the initial findings of an investigation into the use of reinsurance captives by life insurance companies as a capital arbitrage vehicle. The NYDFS found that New York-based insurers and affiliates alone

⁵⁵ Business Insurance, Market Insights, Captive Domiciles 2012.

accounted for \$48 billion of “shadow insurance” capital manipulation. The NYDFS report found that existing state-based disclosure regulations are inadequate, inconsistent, and incomplete to properly identify and regulate these transactions; and that reserves were diverted and risk-based capital was artificially boosted, misleading regulators, investors, and the general public. The NYDFS report identified regulatory inadequacies in transparency with respect to the use of letters of credit, parental guarantees, and other forms of capital permitted by state captive regulators but not disclosed or made publicly available.

To modernize and improve state-based oversight of reinsurance captives, states should develop and adopt a uniform and robust standard for transparency, not only of the liabilities transferred to a reinsurance captive, but also of the nature of the assets that support a reinsurance captive’s financial status. As part of such an oversight regime, states should develop and adopt a uniform capital requirement for reinsurance captives, including a prohibition on those types of transactions that do not constitute a legitimate transfer of risk, *e.g.* that do not provide the protections intended by the Credit for Reinsurance Model Law. Subject to limitations on the disclosure of legitimately proprietary information, these transactions should be disclosed in the financial statements of the ceding insurer. Finally, states should develop and adopt nationally-consistent standards for oversight of the reinsurance captive industry that includes public disclosure of the financial statements of such captives, adopting nationally-consistent standards for oversight of all captives, and adopt those standards as a feature of the Accreditation Program.

Issues Surrounding RBC Methodology and Adequacy Determination

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

The RBC framework has been criticized both on the basis that it is too prescriptive and rigid and that it is too permissive and fails to adequately capture economic and other risks. For example, one stated shortcoming is that RBC applies a single framework to all insurers regardless of size, complexity, and risk profile. Other criticisms of the RBC methodology are that it relies on static statutory accounting valuation of assets and liabilities instead of economic valuations, that it uses pre-determined factor-based calculations instead of dynamic risk models, and that the risk weights for certain assets and liabilities should be modified (*e.g.*, those for investment assets and reinsurance recoverables⁵⁶). The criticisms also state that the current RBC methodology lacks explicit quantification for key risks, that certain risks are currently not captured in RBC at all (such as catastrophe and operational risks, the so-called “missing risks” issue), and that the risks are calibrated in a manner that is not clear or consistent. State regulators are reviewing the RBC framework and intend to address certain of the foregoing criticisms of the methodology, including the “missing risks” issue and adjustment of certain risk weights.

To complement RBC requirements, state regulators have also begun to develop a risk assessment regime whereby insurers make annual self-assessments of capital adequacy and report those annual determinations to state regulators. The self-assessments, known as ORSA, would include stress testing and a requirement to detail risk management systems and policies. If adopted by the states as presently contemplated, the self-assessment obligations would apply both to a statutory insurance entity and to a consolidated group engaged in the business of insurance. For firms operating in the United States and also the EU, consideration should be given to the convergence of EU and state-based ORSA requirements in order to minimize redundant or duplicative reporting requirements for participating insurers.

As state regulators work to refine the RBC methodology and develop ORSA, two important considerations should be kept in mind. First, programs such as ORSA present the question of whether state regulators possess sufficient resources with the prerequisite technical skills and experience to review the

56 This refers to the counterparty credit risk associated with a reinsurer paying an insurer for the insurer’s incurred losses.

complex insurer self-assessments of risk and capital adequacy. If ORSA requires significant investments in actuarial modeling expertise and professional services, state regulators may confront significant challenges to meet those needs. If state regulators move to reliance on third-party contractors for an ORSA assessment, a uniform national standard should be used to determine qualified contractors, as well as a means to assure that state regulators adequately understand, and are accountable for, the work and findings of such contracted specialists.

Second, solvency oversight and capital adequacy principles should be attuned to international developments and should endeavor to integrate best practices, standards and principles that are developed through international consensus. As major participants in the business of insurance become increasingly global in operation, it is important for insurance regulatory authorities to guard against capital arbitrage across international jurisdictions.

Reserving

For insurance purposes, reserves are liabilities that are reported on insurers' balance sheets for the ultimate payment of future losses and policyholder benefits. Reserves are often set using factors and rates determined by an insurer's actuary consistent with guidelines established in state law for insurance products. Reserve levels for insurers operating in the United States and offering certain life insurance and annuity products have been set according to a state law rules-based formula that, insurers claim, results in excessive reserves that detract from the insurer's ability to maximize the value of its capital. For example, in the life insurance sector, insurers complain that reserve requirements for certain products fail to reflect current mortality rates and fail to integrate the insurer's particular business mix and risk profile.

Principles-Based Reserving

Recommendation: 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.

As required by state law or regulation, life insurers currently calculate reserves for life insurance policies based on a standardized formula prescribed by the Model Standard Valuation Law (SVL) of the NAIC. Although the SVL's prescribed valuation mortality table is based on U.S. population data and contains a prudent margin for reserving, the reserve calculated is not specifically tailored to the circumstances of any insurer because it does not consider more particular attributes of policyholders in individual insurer portfolios. Critics of the current formula-based approach to reserving for life insurance contend that it: (1) is static and too conservative; (2) fails to capture all the particularized risks inherent in increasingly complicated life insurance benefits and guaranties; and (3) does not reflect life insurers' business practices, such as the hedging of risk through derivatives use plans. However, reserves are subjected to an annual asset adequacy test analysis to verify the adequacy of reserves through different stochastic and deterministic models, with additional reserves established if necessary. Many industry participants argue that redundant reserve requirements force reliance upon reinsurance captives in order to reduce excessive reserves and allow life insurers to efficiently use capital.

For nearly a decade, state regulators have been considering a move to principles-based reserving (PBR) to address these concerns. Whereas the formula-based approach to quantifying reserves uses standardized calculations, PBR relies upon an insurer's internal risk modeling and analysis techniques, including the use of insurer-specific claims experience with specific portfolios of business, to incorporate consideration of particularized risks and thereby to more closely tailor calculations to the actual attributes

of insurer portfolios. State regulators adopted a supporting *Valuation Manual (Manual)* at a December 2012 NAIC meeting that contains details of the principles-based approach and defines the methods for calculating life insurer reserves. However, legislative adoption of the revised SVL by a supermajority of states (42) representing at least 75 percent of the nationwide premium volume is needed along with a supermajority NAIC adoption of the *Manual* before the *Manual* and PBR become operative.

The difficulty with consistent adoption, interpretation and enforcement of a principles-based approach under the current system of insurance legislation and regulation was evident through the Valuation of Life Insurance Policies Model Regulation (Regulation XXX), which establishes reserve requirements for life insurance products with secondary guarantees, and Actuarial Guideline 38 (AG 38). AG 38 was first adopted by the NAIC in 2003 to address questions pertaining to Regulation XXX such as clarifying reserve requirements for new universal life insurance product designs. AG 38 was revised in 2005 to clarify guidance applicable to sophisticated shadow fund designs and in 2007 to provide an interim solution for reserving for universal life with secondary guarantees with respect to certain matters. Notwithstanding these revisions and clarifications, different state regulators had different interpretations regarding the meaning of AG 38, resulting in competing firms holding more (or less) capital in reserve, depending on the jurisdiction. This state-by-state variance led to competitive imbalances and substantial criticism from industry participants and observers. State regulators have pursued a solution whereby reserving for prospective policies is premised on an agreement negotiated between several states and the life insurance industry, but the agreement does not address marketplace imbalances that result from previously divergent state regulator interpretations. As even this example of a successful compromise demonstrates, full consistency among states is difficult to achieve.

The U.S. life insurance sector's reserving requirements should properly reflect current mortality rates, the life insurer's business model, and its particular risk profile, but substantial concerns arise with the prospect of a wholesale adoption of PBR. In addition to consistency issues, state regulators will also face the challenge of maintaining a sufficiently high level of expertise for understanding the "black box" of the models on which reserve levels would be established. Specifically, the need for many more sufficiently trained and expert actuaries and examiners than are currently available to regulators raises necessary questions with respect to the states' ability to verify insurers' implementation of PBR in a uniform manner that is consistent with the *Manual*. Furthermore, the state-by-state interpretation and application of PBR means consistency across the states will be difficult to achieve. To obtain necessary expertise, states likely would have to contract with consulting actuaries and other professionals, many of whom may have clients in the life insurance industry and, thus, state regulators will need to sort through and manage potential conflicts of interest.

Following the leadership of New York, state regulators in California, Florida and North Dakota, among others, established a working group through the NAIC to recognize the challenges of implementing PBR but allowing the implementation to move forward. Recently, however, the NYDFS identified flaws and raised serious questions about the efficiency of the working group process. Some industry leaders oppose the effort as an initiative that could lead to further weakening of the state solvency oversight regime.

States should move forward with substantial caution to implement PBR. State regulators require significant additional technical expertise or resources to properly evaluate the rigor and quality of idiosyncratic reserve models that vary among firms within a heterogeneous insurance industry. Therefore, states should also adopt standards for the oversight of the vendors who will provide related consulting services to the states.

Credit for Reinsurance

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

Reinsurance is a risk management mechanism whereby insurers transfer, or “cede,” risk to an “assuming” reinsurer. The state-based capital regime for insurers recognizes the value of reinsurance typically by permitting the insurer to reduce its reserve liabilities in some proportion to the risk that is ceded to a reinsurer. This also can reduce the insurer’s capital requirements as determined by RBC.

Under the current state regulatory regime, states insurance regulators do not have direct oversight over non-U.S. reinsurers, but instead regulate the solvency of those U.S. insurers that purchase reinsurance. If a reinsurer is based in the United States, then the ceding carrier receives 100 percent credit on its financial statement to the extent that gross liabilities are transferred, or ceded, to that reinsurer. In most states, however, if the reinsurer is a non-U.S. firm, and if it is not licensed, accredited, or approved by the regulator of the state in which it seeks to provide reinsurance, the reinsurer typically must post qualifying collateral equal to 100 percent of the actuarially estimated reinsurance liabilities that it has assumed from the ceding insurer in order for the ceding insurer to receive full credit. This is true even though non-U.S. reinsurers typically are not required to have a domestic license in order to write business in the United States, and regardless of the financial strength of the foreign reinsurer or the strength of the supervisory regime in the reinsurer’s home jurisdiction. The issue is particularly significant because non-U.S. reinsurers play a large role in the U.S. market, accounting for at least 58 percent of the reinsurance premium volume that is ceded by U.S.-based insurers.⁵⁷

This collateral requirement has long been a subject of discussion within the domestic and international reinsurance sector. Proponents of collateral requirements often refer to the importance of reinsurance recoverables to the U.S. insurance marketplace. Others point to the solvency impact on the primary insurer in the absence of adequate collateral if reinsurance fails to deliver according to a contractual promise. Critics of the current system, on the other hand, maintain that a determination of whether a reinsurer should post collateral should be more sensitive to evolving risk-based considerations. Other related questions in this discussion have been the basis and extent to which regulators should recognize the capital regimes in reinsurers’ home jurisdictions, the impact of collateral requirements on reinsurance capacity, and the increased costs for insurers and consumers.

In November 2011, state regulators, working through the NAIC, unanimously adopted amendments to the Credit for Reinsurance Model Law and Regulation (Model Collateral Law) that, if enacted at the state level, would authorize the state regulator to certify unauthorized reinsurers for reduced collateral regulatory standards. As of July 2013, the NAIC reports that 18 states have adopted some form of authorization for the state regulator to accept less than 100 percent collateral from non-U.S. reinsurers, but the authorization is not uniform in structure or implementation. Among other requirements of the Model Collateral Law, for an unauthorized reinsurer to be certified, the reinsurer must be domiciled and licensed in a jurisdiction deemed to be “qualified.” The determination of whether a non-U.S. jurisdiction is qualified would be made by each state regulator, based on the quality of regulation in the non-U.S. jurisdiction, among other criteria. If a state regulator concludes that a non-U.S. jurisdiction is qualified, the Model Collateral Law, if applied, would then require the state to make a further determination as to the quality of the reinsurer. The state is to assign a “secure level” rating based, at least in part, on the opinion of a CRA. This rating would then be used to determine the minimum level of collateral required by the reinsurer for the ceding insurer to receive 100 percent credit against capital requirements for the reinsurance.

⁵⁷ Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market – 2011 Data* (2012).

Recent state regulator action on this topic has been noteworthy and constructive. The Model Collateral Law represents a step forward but it remains incomplete. For example, a determination by one state within the United States of the adequacy or the equivalence of regulation by another nation would not bind other states. One consequence might be that a foreign jurisdiction could link insurance determinations by a state to other economic or regulatory issues pending between the United States and the affected foreign jurisdiction, possibly frustrating broader U.S. economic or regulatory policy.⁵⁸ The Model Collateral Law also has other features that require further deliberation. For example, it depends too heavily upon assessments of reinsurers' creditworthiness by CRAs. It would be preferable for other, more risk-based empirical factors to be the basis upon which to determine creditworthiness. Sound credit risk management practices by ceding insurers, and not reliance on CRAs or regulatory measures, should be the basis on which collateral relief is provided.

Under Title V of the Dodd-Frank Act, FIO and the United States Trade Representative (USTR) are authorized, jointly, to negotiate and enter into "covered agreements." Specifically, such "covered agreements" would relate to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation. Such agreements may be necessary to impose uniformity on a prudential insurance matter of national interest.⁵⁹ As part of such an analysis, FIO would consider pending prudential regulatory issues affecting the United States and relevant foreign jurisdictions.

FIO is authorized to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters. In formulating federal policy, FIO is well-positioned to make determinations regarding whether a foreign jurisdiction has sufficiently effective regulation and, in doing so, would consider other economic or regulatory issues pending in the United States and between the United States and affected foreign jurisdictions.

State regulators have worked constructively to move forward with enactment and implementation of the Model Collateral Law. Given the likelihood that the Model Collateral Law would be of non-uniform application, together with the complicating effect of state-by-state inconsistency on economic matters of national interest, the circumstances warrant the pursuit of covered agreements for reinsurance collateral requirements. Indeed, the Model Collateral Law could form the basis for such covered agreements. To afford nationally uniform treatment of reinsurers, FIO recommends that Treasury and USTR pursue a covered agreement for reinsurance collateral requirements based on the NAIC Credit for Reinsurance Model Law and Regulation.

Corporate Governance – Director and Officer Suitability and Fitness

Recommendation: 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.

Corporate governance is a broad and expanding area of supervisory interest, particularly for those firms based or operating in the United States that also have international operations. Accordingly, state regulators do have a practice of checking the fitness of insurer management and directors, as they consider the background of officers in determining whether that person is suitable to act as an insurance executive or key owner. When an insurer is initially formed, for purposes of issuing a license to operate, state regulators evaluate the character and fitness of prospective owners, directors or officers by evaluating the individual's biographical information. In some instances, this review is limited to determining whether the individual has a history of criminal wrongdoing. After an insurance entity is

58 See *AIA v. Garamendi*, 539 U.S. 982, 124 S. Ct. 35 (2003).

59 "Covered agreement" is defined at 31 U.S.C. §314 (See footnote 10).

operating, state regulators review changes on the board of directors and officers with oversight that is often limited to an evaluation of whether the individual self-reports a prior conviction for criminal behavior. State regulators allow an individual to serve in an insurer's leadership position upon receiving notice, but may later revoke that tacit approval if the individual is proven to be unqualified or a threat to policyholders.

Even though state regulators conduct fitness reviews, there is an absence of state law or regulation applicable to corporate governance specific to insurers. In 2012, the NAIC compiled a summary of existing corporate governance requirements for U.S.-based insurers. With regard to insurance regulation, the NAIC summary described various governance-related aspects of prudential oversight requirements for: (1) an insurer's financial reporting and audit functions; (2) the monitoring of an insurer off- and on-site and through examinations and ongoing analysis; (3) solvency oversight; (4) regulatory authority over transactions; (5) authority of regulators to take corrective action in respect of a troubled insurer; (6) the authority of state regulators to operate a receivership; and (7) other processes such as authority over market conduct examinations and rate regulation. The summary also described non-insurance related governance standards, including from the Securities Act of 1933 and the Sarbanes-Oxley Act of 2002.

The absence of an NAIC Model law or regulation governing insurer corporate governance has also been noted by international authorities. The International Monetary Fund (IMF) conducts a Financial Sector Assessment Program (FSAP) to help countries identify and remedy weaknesses in their financial sector structures, thereby enhancing resilience to macroeconomic shocks and cross-border contagion. FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. For the insurance sector, supervisory practices are measured against the IAIS Insurance Core Principles. In 2009-2010, the IMF conducted an FSAP of the United States financial system, including state regulatory oversight of the insurance sector. In its review, the IMF concluded there are "no NAIC model laws or regulations that address corporate governance directly."

Notwithstanding the absence of authoritative rules and guidelines, insurers have increasingly focused on governance and risk management matters since the financial crisis. In recent years, for example, many insurers have elevated the prominence of a chief risk officer within the corporate hierarchy. In addition to increased focus by insurers, regulatory authorities and standard-setting bodies have been engaged in sustained work on corporate governance issues.

The focus on corporate governance should continue and become more defined. Many U.S.-based insurers are expanding rapidly in geography, size and complexity, thereby imposing even greater demands on leadership. For example, internationally active insurers are increasingly engaged in sophisticated enterprise risk management practices to measure and understand risks posed to the enterprise from any angle or perspective. With standards appropriately scaled to the size and complexity of the firm, state regulators should adopt director and officer qualification standards that require individuals serving in those roles to have the expertise to assess strategies for growth and risks to the enterprise. For an insurer that exceeds size and complexity thresholds, state regulators should adopt an approach designed to ensure that individuals nominated to serve in the firm's leadership ranks have sufficient capacity to understand and challenge an insurer's enterprise risk management.

Group Supervision

Recommendation: (1) 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; (2) state regulators should build toward effective group supervision by continued attention to supervisory colleges; and (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.

State regulators are authorized to supervise insurers at the individual entity level, but lack the legal authority to supervise a non-insurance affiliate or any affiliate domiciled and operating outside of the state. These inherent limitations of state law constrain any particular state regulator from conducting oversight over or obtaining information regarding the operations of a multi-jurisdictional insurance group such as a large, complex global insurance firm.

The absence of state regulatory authority over non-mutual holding companies (*i.e.*, solo entity supervision) and the existence of only indirect authority over non-insurance entities within an insurance group raise concerns with respect to regulatory acceptance of U.S. insurance firms that desire to engage in the business of insurance outside of the United States. International supervisors from other developed and emerging economies – markets in which U.S.-based firms are seeking to expand – continue to evaluate the relative strengths and weaknesses of solo entity supervision, particularly with respect to solvency matters. To date, actions taken against U.S.-based firms to remedy shortcomings of state-based solo entity supervision have been few, but that may change in the coming years. For example, non-U.S. supervisors may determine that solo entity supervision is inadequate for large, complex financial firms, especially when those firms have significant market share; if so, then the foreign supervisors may take unilateral remedial action against those firms.

Experience with recent insurer insolvencies, moreover, illustrates that a comprehensive understanding of an insurance group could have resulted in a safer and more stable system. Since 2000, the largest U.S. insurer insolvencies were attributable to a variety of causes, but the important facts in common among these cases indicate that a group regulator armed with comprehensive supervision of the enterprise may have prevented those failures or resulted in earlier action that could have stemmed the losses. One firm failed due to mismanagement and fraud, including the shifting of assets between affiliates and the holding company that could more easily have been detected absent the diffusion of state regulatory responsibility. Another firm failed due to inadequate rate-setting which, if subjected to appropriate enterprise risk management oversight, could have exposed deficient pricing, inadequate reserves and the inadequacy of support by the holding company for its licensed entities. A consolidated group supervisor with knowledge of an insurer's enterprise risk management and intra-company transactions, together with the appropriate authority, could have been in a position to improve the supervision of the failed firms to help assure the safety and soundness of those firms.

The limits on state regulatory authority hamper effective regulation at a time when insurers are increasingly part of internationally active, diversified financial conglomerates that engage in a variety of non-insurance businesses. The inability of this regulatory structure to account for consolidated supervision was evident during the financial crisis, particularly in the case of AIG. The Dodd-Frank Act partly addresses this shortcoming of the state regulatory system by introducing provisions on consolidated supervision of the financial activities of nonbank financial companies supervised by the Federal Reserve, as determined by the Council. However, the insurance regulatory system itself should be reformed to provide for group supervision.

State regulators have taken steps to improve solo entity supervision and to make such entities less vulnerable to the weaknesses of affiliates or the group. For example, the regulations of many states require prior approval of certain investment and reinsurance transactions between insurers and non-insurer affiliates, and generally require prior approval by the state regulator before capital can be removed from an insurer.

State regulators may also have the indirect authority to seek information concerning a non-insurer parent or affiliate. Specifically, through the NAIC, state regulators adopted a revised Model Insurance Holding Company System Regulatory Act and Regulation in 2010 (Holding Company Model Act), which grants the state regulators only indirect authority over non-insurance affiliates and the holding

company. However, given that direct state regulatory authority is limited to the state-licensed legal entity, there are substantial questions as to how effective the Model Insurance Holding Company System Regulatory Act and Regulation can be and whether the law's indirect authority actually grants insurance regulators effective authority over non-insurance affiliates or holding companies. The NAIC has reported that the revised Holding Company Model Act has been adopted in 14 states and is pending in 15 others. The actual statutory language and implementation has varied among those states in which the Holding Company Model Act has been adopted.

In addition to the Holding Company Model Act, state regulators, working through the NAIC, are evaluating enhancement of group supervision as part of the SMI process. The principal proposal in SMI adopts a “windows and walls” approach that would “provid[e] a window into group operations, while building upon, rather than rejecting, the existing walls which provide solvency protection,” to insurers. The proposal identifies the following “regulatory windows”: (1) the coordination of state participation on a national level for sharing information with international regulators; (2) supervisory colleges for internationally active groups; and (3) access to information about unregulated entities within the holding company system.

The NAIC is considering additional guidance in its *Financial Analysis Handbook* to address group-wide supervision. The proposed changes cover topics such as the scope of group supervision, coordination and cooperation with supervisors in other jurisdictions, holding company and group-wide financial analysis, a financial examination assessment, roles and responsibilities of the group-wide supervisor/lead state, corporate governance, enterprise risk management, and the supervisory college.

The state of group supervision in the United States has drawn international attention. In its 2010 FSAP, for example, the IMF stated with respect to insurance group supervision: “The U.S. approach is focused on securing the financial soundness of individual insurance companies. While this has not been unusual among insurance regulators internationally, many have been supplementing their strong solo company focus with financial and other requirements and more supervisory focus applied at the group level and U.S. supervisors should do the same. They do not currently make an assessment of the financial condition of the whole group of which a licensed insurance company is a member.”⁶⁰

In the absence of direct federal regulation of insurance groups, supervisory colleges will be an important means of addressing the conduct of group supervision in the intermediate term. The IMF similarly recommended that the United States further develop group supervision and establish international supervisory colleges to supervise U.S.-based insurance groups with international operations.

A supervisory college should be a forum that includes all of an insurance group's functional regulators, both domestic and international, to meet and to share information relating to the supervised group, and identify trends or areas of strength or weakness within the group. A supervisory college should also establish a system in support of group supervision and offer a formal mechanism for increasing regulatory communication and collaboration. For example, the IAIS ComFrame project will significantly improve the operation, efficiency, and substantive value of supervisory colleges for both supervisors and insurance groups. States have undertaken good faith efforts to establish and operate supervisory colleges, and many are in the nascent stages of development.

Supervisory colleges established for U.S. firms operating nationally and internationally, and for non-U.S. firms with large operations in the United States, should also include FIO in light of FIO's statutory mission to monitor all aspects of the insurance industry, including issues or gaps in regulation, and FIO's significant role with respect to financial stability. The financial stability perspective brought by

60 IMF, United States: *Publication of Financial Sector Assessment Program Documentation — Detailed Assessment of Observance of IAIS Insurance Core Principles (2010)*.

FIO would be important for the functioning of the supervisory colleges and, similarly, the information made available to FIO through activity in the supervisory college would be highly significant to FIO's explicit statutory role as financial stability monitor for the insurance industry.

Supervisory colleges are necessary but not sufficient, and do not completely substitute for a consolidated regulator. For example, members of a supervisory college may find it difficult to reach consensus on important issues and the processes by which the college decides or acts may prove to be inefficient. Given concerns about the adequacy of solo entity supervision for larger groups, particularly for U.S.-based firms operating globally, consolidated supervision for large, internationally-active U.S.-based insurance firms will require continued focus and national attention.

Resolution of Insolvent Insurers

The resolution of insolvent insurance entities is governed by state receivership law, specifically the law of the insurance entity's state of domicile. Recent developments stemming from the financial crisis, however, have prompted re-evaluation of the extant resolution regime for insurance entities. While there already have been reforms with respect to the resolution of large, internationally active insurers, further reforms of the resolution regime should be considered.

Resolution of Large, Internationally Active Firms

Establishing an authority that would implement an orderly resolution of a failed financial firm is an essential component of the Dodd-Frank Act. In the case of insurance firms, the Dodd-Frank Act provides that orderly resolution under Title II will take place under prevailing state law. In addition, before the Secretary may make a determination on whether to seek the appointment of the FDIC as receiver of an insurer under Title II, the Secretary must first receive a written recommendation from the FIO Director and the vote of two-thirds of the Governors of the Federal Reserve then serving.

Although resolution of a licensed insurance entity largely occurs under state law, a number of factors suggest that it would be important for resolution planning for complex, global insurance firms to involve analysis and preparedness extending beyond the framework of state-based receiverships and guaranty funds. Consideration of resolution plans for complex U.S.-based national and international insurance firms indicate, for example, that: (1) non-insurance subsidiaries, affiliates and holding companies do not participate in guaranty funds or state-based receiverships; (2) insurance entities may sell products excluded in whole or in part from guaranty fund protection; and (3) insurance entities are not always included in the guaranty fund scheme. These realities mean that, in some cases, a significant part of the activities of an insurance group will fall outside of the states' resolution scheme for insurers. In these cases, separate, holistic orderly resolution plans should be developed for globally active insurers.

Resolution of insurers is a focus of the international regulatory agenda. In that regard, in 2013, the FSB stated that it will focus on three main objectives: (1) addressing the remaining obstacles to implementation of resolution strategies such as cross-border cooperation and information sharing among supervisors; (2) launching an effective assessment process to evaluate the resolvability of all global systemically important financial institutions, including G-SIIs; and (3) developing guidance for the resolution of insurance and other nonbank financial institutions.⁶¹ With respect to insurance in particular, the FSB will initiate a thematic peer review on resolution regimes. This will include a cross-jurisdictional review of the adequacy and effectiveness of resolution regimes for nonbank institutions, including insurers, particularly if the failure of those firms could raise financial stability concerns. The FSB is

61 Financial Stability Board, Press Release, Meeting of the Financial Stability Board in Zurich on 28 January (2013).

working with the IAIS to develop further guidance on the features and powers necessary for resolution regimes to meet FSB standards.

Receivership

Recommendation: 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.

Insurer resolution proceedings typically begin with the filing of a petition by a state attorney general, acting on the recommendation of the regulator of the insurer's domicile. If the petition is granted, the state regulator will be appointed receiver. Once the insurer is in receivership, the state regulator generally has three options: conservation; rehabilitation; or liquidation. In a conservation, the state regulator attempts to preserve the *status quo* while additional information is gathered to determine whether a more assertive approach in receivership (*i.e.*, rehabilitation or liquidation) is needed. In a court-supervised rehabilitation, the state regulator submits to the court a plan to restore the insurer to a solvent capital position. If a feasible rehabilitation plan cannot be developed, or is proposed but not approved by the court, or if the plan proves unsuccessful, a state regulator will then seek a court order allowing for liquidation that will lead to distribution of any insurer assets to policyholders and claimants in accordance with state law.

The determination as to whether and, if so, when to place an insurer into conservation, rehabilitation, or liquidation is subject to the discretion of the domestic state regulator. State political, consumer, and economic development issues may impact the timing of state regulator action. Furthermore, permitted accounting practices can subvert the intent of other solvency tools, such as RBC. The NAIC created the Financial Analysis Working Group (FAWG) to provide a forum of peers to engage with domestic state supervisors of a troubled insurer. FAWG is often cited by the NAIC as an effective means to help states consider appropriate courses of action. Nonetheless, any course of action is entirely dependent upon the authority, discretion, and will of the domestic state regulator.

Following the solvency crisis in the 1960s, states adopted resolution laws and receivership protocols in certain important areas. For example, state laws generally protect policyholders and claimants in a receivership proceeding by elevating those claims to priority over other creditors. Policyholder and claimant protection sometimes takes the form of ring-fencing some assets of an insurer's receivership estate and prohibiting the use of those funds to pay other estate liabilities. An example of such ring-fencing, which has widespread adoption among the states, is protecting owners of variable annuities backed by "separate accounts," which hold assets that are largely segregated from the insurer's general assets and liabilities.

Beyond issues surrounding policyholder and claimant protection, however, insurer resolution laws vary both in specific terms and in application across different states. There have been efforts to impose greater uniformity on state receivership laws. In 1978, state regulators developed the first model law on insurer resolution. To date, however, only 32 states have adopted this template in whole or in part. In 2005, the NAIC published the Insurer Receivership Model Act but, to date, only two states have enacted legislation based on this model law.

One important area in which there are state-by-state differences is the treatment of derivatives and other qualified financial contracts (QFCs) once an insurer is in receivership. The federal bankruptcy code provides protections to counterparties on QFCs by exempting these transactions from the automatic stay and allowing counterparties to terminate and close out QFCs on a net basis. While the

Federal Deposit Insurance Act (FDI Act)⁶² and foreign bankruptcy laws also provide similar protections to QFC counterparties, only some state resolution laws do. The lack of inclusion of uniform close-out netting and other protections for QFCs in state insurance receivership laws has potential negative consequences for insurers and for the financial system. For example, an insurer operating in a state with resolution laws that do not include QFC protections may find it difficult and far more costly to participate in derivatives markets. In addition, the absence of these QFC protections in many state laws could have negative implications for financial stability since these provisions are designed in part to reduce interconnectedness between firms. Accordingly, states should adopt a uniform approach to address the closing out and netting of QFCs with counterparties.

The status and cost of a receivership estate are issues in which policyholders and other creditors have a keen interest, but too often there is a lack of sufficient, clear, and timely information. In 2008, the NAIC announced the release of its Global Receivership Information Database (GRID) which serves as a publicly accessible repository of information about open and closed estates being administered by state insurance regulators (or their designees) as receiver. GRID includes administrative elements such as contact information for the receiver, court order references, lines of business that had been written by state, and distributions. The database also provides an opportunity for the receiver to post a financial statement for the estate. The NAIC reported as of March 31, 2013 that there are wide variances among the states as to the extent of information that has actually been made available through GRID, with the data submitted by many states as being less than 25 percent complete. Furthermore, the nature, form, extent, and timeliness of financial information about insolvent insurers and pertinent disclosures by receivers are inconsistent, if available at all. Receivers use various bases of accounting (*e.g.*, cash basis, modified cash basis), with widely varying degrees of detail as to disclosures accompanying the financial statements. States should develop requirements for transparent financial reporting by receivers about the insolvent estate as well as the costs of administration that have been incurred, require timely preparation and filing of reports on a regular basis, and make pertinent aspects of this information publicly available.

Guaranty Funds

Recommendation: 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.

One condition for operating an insurer in a state is the insurer's participation in the state guaranty fund. State guaranty funds provide for the timely honoring of policyholder claims asserted against an insolvent insurer.

Guaranty funds are administered by state guaranty associations, which are created by state law typically as nonprofit entities and are subject to the oversight and direction of insurers licensed in the state. Most states have established separate funds for different lines of insurance, *e.g.*, separate funds for P/C and for L/H coverage.⁶³ Guaranty associations dedicated to each line of business participate in national associations – the National Conference of Insurance Guaranty Funds (NCIGF) and the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA).

62 Both the FDI Act and the Orderly Liquidation Authority in Title II of the Dodd-Frank Act provide for a temporary 24-hour automatic stay.

63 Not all insurance lines are covered by guaranty funds, including financial guaranty, mortgage insurance, and title insurance. Some states also exempt health maintenance organizations (HMOs) requiring solvent HMOs operating in the state to assume the policies and enrollees of the insolvent HMO. Additionally, some insurance companies offer non-insurance, non-annuity products such as guaranteed investment contracts (GICs) which are also not covered by guaranty funds.

In the event of an insurer's insolvency, guaranty associations may take a range of steps to offer continuing protection to policyholders. For example, in the typical insolvency of a P/C insurer, state guaranty associations step in to pay the portion of claims within the limits guaranteed by the respective state association. In a L/H insolvency, state guaranty associations may arrange continuing insurance coverage for the failed insurer's policyholders; that can involve entering into "assumption reinsurance" agreements with healthy insurers, whereby the healthy insurer assumes policy liabilities in return for a transfer of the failed insurer's assets. NOLHGA may often assist the various state L/H guaranty associations in the negotiation process and in the transfer of liabilities arising from multi-state L/H insurer insolvencies to a solvent carrier. Guaranty associations may also assume liabilities until such liabilities run off, although this path is less frequently taken.

NCIGF reported that, through 2011, its member guaranty funds have paid more than \$26.4 billion to claimants since 1976. NOLHGA states that its members have protected consumers in roughly 75 multi-state insolvency cases involving life and health insurers. NOHLGA reports that a significant life insurer has not failed since the early 1990s.⁶⁴ However, despite significant apparent capacity in the guaranty fund system, it is unclear how the system would fare in the event of a failure of a large insurance group in the United States. Furthermore, an event that would cause such a scenario would likely impact other insurers as well. Just as insurers perform stress tests under adverse scenarios, NCIGF and NOLGHA should periodically model the potential adverse impacts of such scenarios on the guaranty fund system for review by FIO.

While guaranty funds address many of the consumer protection deficiencies that were experienced during the solvency crises that occurred in the 1960s, 1980s, and 1990s, some important consumer protection considerations remain. For example, laws concerning product pay-outs by guaranty funds to policyholders are not uniform across states. For claims against P/C insurers, maximum payouts per claim are generally set by statute between \$100,000 and \$500,000, with most state laws imposing a \$300,000 cap. For claims against life and health insurers, guaranty funds provide at least \$100,000 in coverage for health claims, \$300,000 for life claims, \$100,000 for cash surrender/withdrawal values, and \$100,000 for annuity claims. Although these figures define the general range of protection, there are significant variations among states on these figures. For example, an annuitant in New Jersey is eligible for up to \$500,000 of guaranty fund protection, but an annuitant in Indiana with the same product is eligible for up to \$100,000 in guaranty fund protection. Consumers who purchase the same coverage or product from the same company may receive a different guaranty fund benefit if they reside in different states at the time the insurer is placed into receivership.

States should enact uniform policyholder recovery rules so that all policyholders, irrespective of where they reside, receive the same benefits from guaranty funds. In the event that states fail to achieve uniformity with respect to guaranty fund benefits, then federal involvement may be necessary to ensure fair treatment of all policyholders.

64 However, see Box 3: Assistance to the Insurance Industry during the Financial Crisis.

IV. MARKETPLACE OVERSIGHT, CONSUMER PROTECTION AND ACCESS TO INSURANCE

“Marketplace oversight” refers to those aspects of insurance regulation that concern consumer protection, insurance access, and affordability. Marketplace regulation displays substantial state-by-state variance. This variance was the subject of substantial attention in the decade before the financial crisis and prompted a number of members of Congress to introduce legislation to introduce greater uniformity. Insurers and consumer advocates have criticized this lack of uniformity and the absence of coordination on regulatory matters on grounds of duplication, inefficiency, delay, and uneven consumer protections.

This section reviews the areas that are most frequently the subject of discussion in the area of marketplace regulation: producer licensing; approval of insurance products for sale; market conduct examinations; and collection of tax for multi-state surplus lines. This section also addresses issues of affordability and access to insurance, including rate regulation, risk classification, natural catastrophes, and accessibility of insurance for Native Americans.

Producer Licensing

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

A “producer” is an agent or broker who markets, distributes or sells an insurance product to a consumer. Today, even though an increasing percentage of consumers purchase insurance on-line or through other direct means, insurance products reach the consumer principally through producers. The number of total licensed producers reflects their importance: in 2012, NIPR, an electronic, centralized producer database, reported that nearly 2.3 million individuals maintained more than 6 million state insurance producer licenses.

Producers may not market, distribute or sell insurance in a given state without a license from that state. States have an application process that typically requires providing personal information, completing required education and training, satisfying a background check, and passing a licensing examination. Regulating producers is an important activity for states. Producers often are the principal insurance point of contact for consumers and, therefore, regulating producers’ qualifications directly bears on consumer protection. Producer licensing also generates revenue for the states and state insurance departments.

Although approximately 70 percent of producers maintain a license in only one state, the remaining are licensed in two or more states. The differences in licensing requirements among the states can present duplicative obligations and barriers to entering business in a particular state.

There have been steps to promote greater uniformity in licensing practices and requirements. In 1996, the NAIC, with support from the producer community, developed NIPR, which thereafter established the electronic database through which states may obtain and share information about any current or prospective licensee. NIPR now offers a range of services to aid with licensing, including single and multi-state licenses, single and multi-state renewals, and continuing education verification.

A few years later, in 1999, Congress, in enacting GLBA, set a deadline of November 2002 to require that a majority of the states and territories enact uniform producer licensure laws or adopt reciprocity laws. Under GLBA, failure of the states and territories to meet the producer licensing target would have trig-

gered formation of NARAB, an entity to provide multi-state producer licenses. In response to GLBA, however, state regulators developed the Producer Licensing Model Act (PLMA), which sought to create a framework for reciprocal recognition of producers seeking to be licensed in more than one state. In 2002, the NAIC certified that 38 states and territories adhered to the PLMA, thereby complying with GLBA and avoiding creation of NARAB. As of 2009, the NAIC certified that 47 states and territories were in compliance with the PLMA. After the PLMA, state regulators adopted Uniform Licensing Standards, which provide substantive standards for licensing, renewals, and continuing education requirements.

Notwithstanding these efforts, the inconsistencies and inefficiencies resulting from the absence of uniformity in state producer licensing persist. One fundamental reason is the lack of full participation by the states in the reciprocity and uniformity efforts. For example, many states do not offer the full range of services that NIPR makes available. Moreover, NIPR offers services to help with insurer appointments, or with resident licensing and renewal, but these services are not used by many states. In addition, although the NAIC certified that 47 states and territories had adopted PLMA, three that had not were New York, Florida, and California, which are among the largest of the state insurance markets.

Consumers are detrimentally affected by the absence of uniformity and reciprocity in producer licensing. For example, in an increasingly mobile society, many consumers who move across state lines may prefer to maintain a relationship with a producer based in another state. The National Association of Insurance and Financial Advisors reported, however, that 80 percent of its surveyed members were unable to serve a client who moved to another state, and 12 percent of its members were unable to serve 50 or more clients who had moved to a state in which the producer was unlicensed.

The lack of uniformity creates duplicative administrative and regulatory burdens with no corresponding consumer benefit. Small firms (or “agencies”) seeking producer licenses in multiple states confront significant resource demands. The Independent Insurance Agents and Brokers of America report that more than 1.6 million producers are licensed in more than one state, requiring time and expense to obtain licenses that could otherwise be used to develop and grow the producer’s business portfolio. The resource burden is also felt at large firms. The Council of Insurance Agents and Brokers described one large firm that holds 76,100 licenses nationally for approximately 5,000 licensed individuals, 3,100 of whom are licensed in more than one state. Other firms face similar burdens.

Even adherence to the PLMA does not necessarily result in the needed uniformity. For those states that have adopted the PLMA, reciprocity has not necessarily followed. A business entity that employs individuals who sell, solicit, or negotiate insurance is considered a producer under the PLMA. The reality remains, however, that every state requires these business entities to be licensed producers, which is in addition to the requirement that every individual producer employed by the entity be individually licensed. Some states impose different requirements for the licensing of business entities, including entity appointment requirements, licensing for branch locations, affiliation requirements, and filing of organizational documents. Regardless of the reasons for these differences, each increases the compliance burden without commensurate benefits of consumer protection.

The lack of uniformity persisting in this area, even following explicit Congressional direction through GLBA, warrants Congressional action to establish uniformity and to reduce the burdens of multi-state producer licensing. NARAB II, which has passed the House and is pending in the Senate, would establish NARAB, a corporation solely intended to establish uniformity and efficiency in producer licensing requirements.

Producers licensed through NARAB would be able to conduct business in multiple states, but would not be subject to licensing requirements in every state in which they do business. Rather, they would

be licensed through NARAB with the opportunity to conduct business in all the states. Enforcement of state laws applicable to producers would remain with the state regulator.

If NARAB II is passed by Congress, the focus should shift to successful implementation of the legislation. In particular, the interests of consumers, although not directly represented on the proposed NARAB II governing board, should receive due consideration and remain a priority. Further, the NAIC should develop an appropriate mechanism to integrate the concerns of those states whose regulators, as a matter of state law, are unable to serve on the governing board. Finally, NARAB II must provide producers an efficient and streamlined multistate licensing mechanism. Consistent with its authority to monitor all aspects of the insurance industry, if NARAB II is passed by Congress and signed by the President, then FIO will monitor the establishment and implementation of NARAB II to ensure that these priorities are achieved.

Box 6: Marriage and Insurance

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

Insurers often use marital status as an underwriting and rating factor. Auto insurers and homeowners' insurers often offer a lower premium for the same coverage to married individuals than to a single person. The use of marital status as an underwriting and rating factor may disadvantage an individual who is lawfully married under the laws of another state to a person of the same sex.

Recent years have seen a number of legal and policy developments at the federal and state levels regarding the treatment of same-sex spouses. To note one example, in *United States v. Windsor*⁶⁵ the Supreme Court recently ruled a provision of the Defense of Marriage Act (DOMA) unconstitutional. That provision provided a federal definition of "marriage" and "spouse" to be used in reference to federal laws and regulations, defining marriage as a legal union between one man and one woman, and spouse as referring only to a person of the opposite sex who is a husband or a wife. The Supreme Court found that that provision "violates basic due process and equal protection principles applicable to the Federal Government" under the Constitution's Fifth Amendment.⁶⁶ Following *Windsor*, federal agencies have reviewed and revised regulations and policies to extend federal benefits and obligations of marriage to same-sex married couples, in a manner consistent with law. For example, the Internal Revenue Service allows a same sex couple lawfully married in one state to be treated as married for tax purposes regardless of whether the laws of the state of residence allow for same sex marriage. In addition, at the state level, Illinois recently became the sixteenth state to allow for same-sex civil marriage.

In light of the recent legal and policy developments in the treatment of same-sex spouses, and based on equality considerations and other factors, states should assess whether or in what manner marital status is an appropriate insurance underwriting or rating consideration.

Product Approval

Recommendation: 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.

65 133 S. Ct. 2694 (2013).

66 *Id.* at 2693.

State regulators use product approval, or “form regulation,” to assess whether insurance products comply with state consumer protection laws, such as those governing insurance policy or contract design, pricing, and coverage terms. The process for product review and approval varies by state, as do the standards with which the insurer must comply. For example, some states require approval before a product is offered in the market, but others permit introduction to the market without prior approval, while still other states reserve the option for later review. The duration of review and substantive standards for review also vary, depending on factors ranging from regulatory processes to state resource constraints.

The absence of a uniform national standard and protocol for product approval is a continuing complaint for insurers that argue the lack of uniformity creates inefficiencies and compromises the ability to offer the same products simultaneously and in the same manner on a nationwide basis. Insurers assert further that both speed-to-market and innovation are harmed by product approval delays in many jurisdictions. Consumer advocates note that the lack of uniformity creates opportunities for regulatory arbitrage, both with respect to personal and commercial lines insurance.

Box 7: Personal Auto Policies for Service Members

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

Product approval requirements also can disproportionately impact members of the armed forces. Active duty members of the military may transfer to a different base in the United States every 24 to 36 months, which typically involves the member of the armed forces moving to a different state. An individual on active duty can transfer credit cards, checking accounts, and other financial services simply by submitting a change of address form. By contrast, an individual moving from one state to another may be required to obtain a new auto insurance policy on each transfer.

While state laws differ, FIO will work with federal agencies, state regulators, and other interested parties to identify a more accommodating approach for service members who have personal auto policies and are required to move across state lines. For example, a common form for personal lines auto coverage for active duty members of the military could be developed and adopted so that the member’s transfer to a new base located in another state does not necessitate a new policy form issuance.

Over the years, states have moved to address some of the shortcomings of the product approval process through the IIPRC and SERFF. In July 2003, the NAIC adopted the current IIPRC model law. Upon the adoption of the model in a state, the state is allowed to join the IIPRC. The IIPRC develops uniform product standards and improves speed-to-market and uniformity for life insurance, annuity, disability income, and long-term care products. Through the IIPRC, an insurer may submit a life, annuity, disability income, or long-term care product filing to be reviewed and approved by a single reviewing body operating under unitary standards. If a product is filed for approval with IIPRC, its uniform standards supersede those of any compacting state unless the insurer submits that product directly to the compacting state outside of the IIPRC framework. The IIPRC was brought into existence in May 2006 upon meeting the threshold requirement of 26 states or 40 percent of premium volume nationwide. The IIPRC currently has 43 members (42 states and Puerto Rico). None of the compact members have opted out of the uniform standards for life only or annuities products; five members have opted out of the uniform standards for long-term care; six members do not permit Modified Rate Schedule filings for long-term care; and one member has opted out of the uniform standards for individual disability

products. In 2012, 167 companies registered to file products for approval and submitted 744 filings, resulting in the approval of 625 products. The average approval time for the products was 23 days.

Notwithstanding the strides represented by the formation and function of the IIPRC, for several reasons uniformity and efficiency have yet to be achieved in the area of product approval for life insurance, annuities, long-term care, and disability products. First, state participation in IIPRC is incomplete, largely because California, Florida, and New York have not joined, and the populations of those states constitute a substantial portion of the U.S. insurance market. Second, the scope of product lines eligible for IIPRC review is limited, and the IIPRC has yet to develop approval standards for group annuity, group long-term care or group disability products. Finally, IIPRC permits an insurer to submit an approval request directly to a state IIPRC member, thereby allowing an insurer to circumvent IIPRC standards completely. Accordingly, insurers have the ability to avoid the IIPRC consumer protection standards if those standards are more stringent than the consumer protection standards of the state IIPRC member, thus making IIPRC a regulatory tool susceptible to arbitrage.

Given the shortcomings, dissatisfaction among life insurers persists. In 2011, ACLI's survey of its members found that 83 percent believe that improvement of policy/contract form approval processes is of "critical/major importance." Life insurers assert that the lack of uniformity in a rapidly evolving and growing market for retirement products stifles product innovation.

States should take the following measures in the short term. First, non-participating states should join the IIPRC. For states with a constitutional or legal impediment to joining a multi-state compact, state regulators should adopt the IIPRC product standards and processes as model law and regulation. Second, such standards should serve as a baseline so as to allow states with higher consumer protection standards to continue enforcing those higher standards. Third, to remove opportunities for arbitrage, state regulators from member states should prohibit insurers from opting into less restrictive non-IIPRC standards. Finally, IIPRC should expand the scope of its product coverage and develop standards for all products within its authority.

In 1998, state regulators established SERFF to standardize initial product filings with the regulators and to expedite submitting insurance policy forms for approval. With SERFF, insurers can simultaneously file for product approval in multiple states but the legal and regulatory standards for form review remain different state by state.

Regulatory approval of policies sold to sophisticated commercial policyholders, though presently subject to less regulatory scrutiny than policies for individuals and families, often impose substantial delay and may have the unintended consequence of driving more commercial policyholders to less regulated surplus lines coverage or self-insurance. In a 1998 NAIC white paper entitled *White Paper on Regulatory Re-engineering of Commercial Lines Insurance: Streamlining of Commercial Lines Insurance Regulation*, state regulators recommended, among other things, a flexible regulatory stance for form and rate review in markets found to be competitive by the state regulator, exemptions for large commercial policyholders from form and rate review, and authority for state regulators to waive specific policy requirements for policyholders primarily located in another state. In the 15 years since that white paper the states have made important strides.

Nonetheless, commercial lines insurance regulation must continue to modernize. Inconsistent and sometimes lengthy product approval periods continue to limit the ability of insurers to meet the needs of national businesses with new products. Although most states permit exemptions for large commercial policyholders from rate or form review, the premium volume or number of employees that qualify an insured as a large commercial policyholder vary by state. Additionally, while the creation of SERFF

has achieved efficiency gains, insurers continue to identify inconsistencies in SERFF filing requirements by state that limit those efficiencies for multistate filings.

Recently, the NAIC formed the Commercial Lines (EX) Working Group to ascertain the extent to which states moved forward with the recommendations included in the 1998 white paper as well as to consider additional reforms in the commercial lines market. As part of this work, state regulators should pursue the development of nationally standardized forms and terms, or some mechanism for interstate reciprocity, to streamline and improve the regulation of commercial lines.

Given the importance of efficiency and consistency in the product approval process for many insurance products, FIO should continue to monitor state-based product approval processes. Federal action may become necessary if the current, and long-standing, shortcomings are not improved in the near term.

Box 8: Sale of Annuities to Suitable Consumers

Recommendation: 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.

One of the most important financial decisions facing many consumers approaching retirement is whether to invest their savings by purchasing annuities, shares in mutual funds, or interests in other securities. Financial literacy among consumers varies widely and it is difficult for many consumers to evaluate what investments are most suitable. Whether an annuity is suitable for a particular consumer and what specific contract features best meet the consumer's needs depends upon a variety of considerations, including the consumer's age, income, financial situation, and risk tolerance. In addition to state regulation, federal law, including the Employee Retirement Income Security Act, may govern the provision of investment advice concerning annuities.

All annuities offer the advantage of the deferral of tax on the investment earnings, with the earnings taxed as ordinary income only when the annuitant actually receives the annuity payment. There are three general types of annuities. Fixed annuities pay a pre-determined flat monthly sum. Variable annuities pay a monthly sum determined by the performance of an investment portfolio held in a segregated account. Indexed annuities have a guaranteed minimum payment with the opportunity for a higher payment depending on the performance of another asset or underlying rate or index, such as a selected securities index.⁶⁷ Each of these types of annuities can be paid for a specific period of time or for the life of the annuitant.

State regulators supervise the sale of all commercial annuity products, and licensed insurance producers may sell annuities. In addition, variable annuity products are also considered securities and are regulated by the SEC.⁶⁸ Consequently, licensed insurance producers selling variable annuities must be appropriately affiliated with a member of the Financial Industry Regulatory Authority (FINRA) and comply with registration requirements applicable to a securities representative.

Through the NAIC, following numerous state enforcement actions, state insurance commissioners have attempted to create a national suitability standard for annuity sales. The NAIC Suitability in Annuity Transactions Model Regulation (Model Suitability Regulation) requires: (1) insurance

67 Indexed annuities do not have segregated accounts. Indeed, the insurer may not actually invest in the instruments associated with the underlying rate or index, such as the securities that correspond to the selected securities index.

68 In 1959, the Supreme Court decided that variable annuities are securities.

producers to have reasonable grounds for believing that the recommendation to buy an annuity is suitable for the consumer; (2) insurers to maintain procedures for review of each recommendation to purchase an annuity to determine suitability prior to issuing the annuity; (3) insurance producers to be trained on the provisions of annuities generally; and (4) a safe-harbor for variable annuity sales made in compliance with FINRA requirements.⁶⁹

The Dodd-Frank Act provides incentives for state regulators to enact national suitability standards. The Dodd-Frank Act authorizes the Office of Financial Literacy in the Consumer Financial Protection Bureau (CFPB) to issue grants to states to enhance the protection of seniors from misleading and fraudulent sales of financial products.⁷⁰ State regulators could, for example, apply for the grant if, among other requirements that may be established by the CFPB, the state regulator were to adopt suitability standards that meet or exceed the Model Suitability Regulation. The Dodd-Frank Act also directs the SEC to treat indexed annuities as exempt securities if: (1) the value of the indexed annuity does not vary according to the performance of a separate account; (2) the indexed annuity satisfies state nonforfeiture law or in the absence of such, the NAIC Model Standard Nonforfeiture Law for Life Insurance or NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities; and (3) the indexed annuity is issued in a state that has adopted the Model Suitability Regulation or by an insurer that adopts and implements practices on a nationwide basis for the sale of annuity contracts that meet or exceed the NAIC Model Suitability Regulation.⁷¹

The United States has entered an era of unprecedented levels of retirement age residents. Financial security for the aging population is an essential priority, and that security must be shaped around the unique circumstances of each retiree.

The suitability of an annuity purchase should not be dependent upon the state in which the consumer resides. Given the importance of national suitability standards for consumers considering or purchasing annuities, states should adopt the Model Suitability Regulation. In the event that national uniformity is not achieved in the near term, federal action may become necessary.

Market Conduct Regulation

Recommendation: 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.

Regulators formally review an insurer's compliance with state laws governing market conduct practices through market conduct regulation. Market conduct regulation includes market analysis, investigations and market conduct examinations. Investigations or market conduct examinations may be commenced either as part of a regular schedule or on an ad hoc basis, when the regulator becomes aware of circumstances that raise market behavior concerns, whether through the receipt of information from customer complaints, other supervisors, other insurers, the media, or other sources. Currently, investigations and market conduct examinations may be conducted by the regulator of any state in which an insurer operates and may cover any matter within that state's laws, including licensing, underwriting practices, claims settlement, use of forms, and customer service.

⁶⁹ The Model Suitability Regulation was first adopted in 2003 and applied only to sales to seniors. It was revised in 2006 to apply to all consumers. The model regulation was revised again in 2010. The term Model Suitability Regulation is used here to refer to the 2010 version.

⁷⁰ See Section 989A

⁷¹ See Section 989J, 15 U.S.C. § 77c(a)(8).

Market conduct regulation has been the focus of significant criticism by industry and third-party commentators. The principal reasons are that state regulators often fail to adequately coordinate market conduct examinations, resulting in multiple examinations for the same or similar sets of issues, with all the attendant burdens and inefficiency. A 2003 Government Accountability Office (GAO) report⁷² noted that states not only differed in the rigor and breadth of market conduct examinations – thus raising concerns also about effective consumer protection – but that coordination between states was inconsistent and infrequent.

In response to these shortcomings, state regulators have taken steps to create a more systematic, structured and uniform market conduct regulation program. Although a Market Conduct Surveillance Model Law, adopted by state regulators at the NAIC in 2004, has not been widely adopted, the NAIC *Market Regulation Handbook (Handbook)*, has been adopted by most jurisdictions, and describes the key components and standards for: (1) market analysis; (2) investigations; and (3) market conduct examinations. Aside from adopting common examination protocols, state regulators collaborate and coordinate market conduct regulation through the NAIC Market Actions Working Group (MAWG). This forum permits states to share information gained through market analysis, investigations, or market conduct examinations. Based on this information, a state regulator may proceed with a multi-state market conduct examination.⁷³

Notwithstanding these improvements, when the GAO revisited the market conduct examination process in 2009, it determined that states had improved the process, but that differences among the states still limited progress toward appropriate coordination and standardization of examinations. The GAO acknowledged that states had developed some market conduct guidance, data collection, and analysis tools, but noted that substantial variances continued among the states in terms of process, criteria, and coordination. Indeed, as of 2011, 45 of 56 NAIC jurisdictions required insurers to submit a Market Conduct Annual Statement (MCAS), a compilation of insurer-specific market conduct-related data. However, a 2011 ACLI survey of its members noted continued dissatisfaction with market conduct regulation. The ACLI survey noted that 63 percent of respondents rated current market conduct practices as “unsatisfactory/needs improvement,” with 78 percent citing a lack of uniformity as the major cause of dissatisfaction, along with “speed/timing,” “cost,” and “expertise/capacity.”

State regulators have continued to work on improvements to market conduct regulation and conducted a self-survey to understand current state activities.⁷⁴ A 2012 NAIC survey demonstrates the continued variation in market conduct regulation among the states: one state carried out 66 percent of all interrogatories conducted in 2010, three states carried out 48 percent of all specialized data calls, and one state accounted for 73 percent of all reviews of insurers’ self-audits. The survey asked whether states would be willing to forgo an examination of an insurer if another state had conducted an examination and ensured all of the issues of concern were corrected. Respondents noted this would depend on the comparability of the state’s market conduct examination system, whether the insurer was a domestic insurer, the severity of the issues, and the similarity of state laws.

Coordination between states and standardization of market analysis, investigations and examinations are essential to modernization. Aside from promoting efficiency and consistency, improved coordination could present an opportunity for state regulators to pool already scarce resources. Moreover,

72 Insurance Regulation, Preliminary Views on States’ Oversight of Insurers’ Market Behavior, May 6, 2003.

73 The NAIC developed a number of tools states may use to share information and coordinate market conduct regulation activity. In addition to Market Conduct Annual Statement, these include the Market Initiative Tracking System, the Special Activities Database, the Complaints Database System, the Examination Tracking System, Market Analysis Review System, and Regulatory Information Retrieval System.

74 See NAIC Market Regulation and Consumer Affairs Committee *Market Regulation Survey* August 3, 2012.

standardization provides consistent and uniform consumer protection for all policyholders irrespective of where the policyholder resides.

Under the state-based regulatory system, states should develop a requirement that market conduct regulation be performed according to the *Handbook*, which would significantly improve the consistency of consumer protection across all states. Moreover, as part of the examination protocol, states should develop a process whereby information relevant to the same or similar statutory and regulatory requirements first be sought from another regulator before issuing a duplicative request to the insurer. States should adhere to a “lead state” concept for multi-state market conduct examinations in order to eliminate unnecessary and duplicative examinations.

Another factor that may augment the variability of rigor and professionalism from one state to another is the increasing dependence of state regulators on contract examiners to perform market conduct examinations. States should develop explicit standards and protocols to govern contract examiners including cost and schedule, education, professional background, training requirements, and appropriate ethical standards regarding conflict of interest, confidentiality, privacy and report drafting. State regulators should also develop a list of approved contract examiners based on an objective evaluation of expertise and training to examine specific issues or industry participants.

Rate Regulation

Recommendation: 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. FIO will work with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering such products.

An insurance rate determines the price at which an insurance policy or contract is sold. Insurers use rates to determine the premium due on a particular insurance policy: premium equals the rate multiplied by the number of units of insurance purchased. The rate typically reflects the risk characteristics of the purchaser of insurance.

Rate regulation originated in the late 19th century, when insurers gathered in “bureaus” to set rates because of the concern that price competition would bring the threat of insolvency (“destructive competition”). Rate regulation also evolved to allow insurers to exercise greater discretion when setting rates. Whereas states formerly set a “mandatory rate,” regulation now is generally based on a legal standard, shared by all states, that the rate not be “inadequate, excessive, or unfairly discriminatory.” Today, rate regulation principally addresses affordability.

The evolving views on the manner of setting rates is reflected in the variety of processes through which states now permit insurers to file rates with the state regulator. (See Box 9). However, many empirical studies suggest rate regulation, particularly in auto and homeowner insurance, may adversely impact market supply resulting in higher prices and an increase in the market share of the residual market.⁷⁵

75 See Lauren Regan, Sharon Tennyson, and Mary Weiss *The Relationship Between Auto Insurance Rate Regulation and Insured Loss Costs: An Empirical Analysis*, NAIC 2009; Mary Weiss, Sharon Tennyson, and Lauren Regan *The Effect of Regulated Premium Subsidies on Insurance Costs: An Empirical Analysis of Automobile Insurance*, *The Journal of Risk and Insurance*, Vol. 77, No. 3, 2010; Richard Derrig and Sharon Tennyson *The Impact of Rate Regulation on Claims: Evidence from Massachusetts Automobile Insurance*, *Risk Management and Insurance Review*, 2011, Vol. 14, No. 2, 173-199; and Sharon Tennyson, *The Long-Term Effects of Rate Regulatory Reforms in Automobile Insurance Markets*, Insurance Research Council, March 2012.

Box 9: Forms of Rate Regulation

States exercise varying degrees of rate regulatory authority. Listed from the least to most stringent, the different types of rate regulation include:

- *Open rating:* Insurers establish rates for the products with a presumption that the rates satisfy the state standard. The state regulator intervenes only in limited circumstances.
- *Use and File:* An insurer releases a product with certain rates, while also submitting a rate filing for review. The regulator can object or disallow the filed rate within a fixed number of days after the request to review. If the regulator does not object to or disallow the proposed rate within the allotted timeframe, the insurer can continue using the rate in the market. In some states, if the rate request is disallowed within the review timeframe, the insurer is required to rebate the premiums already collected.
- *File and Use:* An insurer files a rate request with the state regulator who has a fixed amount of time to review the filing. If the regulator does not take action within the allotted timeframe, the rate is deemed approved and the insurer implements the rates in the market.
- *Prior Approval:* An insurer files a rate request with the state regulator and cannot implement the proposed rates until approved by the regulator.

In 2011, 35 jurisdictions required a prior approval process for some lines of coverage, 37 jurisdictions utilized a file and use process, four jurisdictions utilized a flex band rating scheme, 16 jurisdictions required use and file process, and 33 jurisdictions had no filing requirements for commercial lines except upon demand of the regulator. States often use a particular approach for rates dependent upon the line of insurance. In general, however, rates for personal lines typically receive a higher degree of scrutiny than commercial lines and, therefore, rates for personal lines are more likely to be required to go through a prior approval process.

Proponents for an open market system argue that prior approval rate regulation unnecessarily injects local political dynamics into a private economic market. Some argue more broadly that rate regulation artificially depresses prices, forcing insurers out of otherwise important markets and distorts the real cost of insurance. Supporters of strict rate regulatory authority argue that such regulation is critical for providing affordable and accessible insurance. Proponents of open market systems counter that, as an “open market” state, Illinois does not regulate base rates for affordability, but relies on the competitive market to impose discipline on prices and cite as evidence that more insurers participate in the Illinois P/C markets than in any other state.

The “open market” approach is not the only alternative to strict rate oversight. In 2011, Tennessee adopted a “flex band rating” approach for personal lines policies that allows insurers to impose rate increases within a range of 15 percent of the prior year’s rate. In 2011, Connecticut extended for another two years a flex band rating (originally enacted in 2006) for personal lines that allows insurers to impose rate increases within a range of 6 percent of the prior year’s rate. These recent developments may indicate a trend among the states to consider alternatives to strict rate regulation.

Rate regulation processes and protocols are fertile areas for experimentation by the states. With different states testing alternative approaches to rate oversight, states can evaluate the results in other jurisdictions and identify best practices. States pursuing enhanced competition and capacity in personal lines insurance markets have the option of pursuing moderate rate regulatory reforms on a limited or pilot basis to test the view that the burdens of rate regulation deter competition and reduce market capacity.

In making a determination regarding whether or how to implement a pilot program a number of factors may be considered. In order to define the factors state regulators may use to make such a determination, it is important to understand the characteristics of a competitive market that provide sufficient market discipline to maximize the number of insurers offering products to consumers. FIO has authority to monitor the affordability and accessibility of non-health insurance products to traditionally underserved communities. In the exercise of this authority, FIO will continue to monitor developments in the area of rate regulation and work with state regulators to identify best practices for implementation of pilot programs, as well as best practices for monitoring the impact of any change on consumer access to insurance.

Risk Classification

Recommendation: (1) States should develop standards for the appropriate use of data for the pricing of personal lines insurance; (2) states should extend regulatory oversight to vendors that provide insurance score products to insurers; (3) FIO will study and report on the manner in which personal information is used for insurance pricing and coverage purposes.

In determining the insurance rate applicable to particular customers, together with eligibility for coverage and class of service, insurers increasingly consider a myriad of data points to determine an individual consumer's risk profile. In the context of personal lines insurance products, this practice is familiarly known as "risk classification." Many P/C insurers generally rely upon these methodologies, for example, to place a customer in a particular rating tier, which can carry particularized coverage limits and premium prices

The increasingly prevalent methodology for determining risk profiles for P/C personal lines is to rely on insurance scores. Insurance scores are typically generated by algorithms that consider a large number of data points, including an applicant's driving history, age, gender, zip code, marital status and credit score, or the components of a credit score. Some estimates indicate that, to one degree or another, the vast majority of auto insurers factor in credit scores, or components of a credit score, when determining applicable policy rates. The impact of applying these scores can be substantial. For example, some studies suggest that a driver with a poor credit score may pay 40 percent more in premiums.

Proponents of insurance scores argue that the more data an insurer can collect about an applicant, the more accurately the insurer can evaluate risks and price the policy. They also assert that the accurate pricing enabled by an insurance score reduces the cost shift in an insurance pool in which consumers with a lower risk profile subsidize the costs of individuals with a higher risk profile. These arguments are made with particular reference to individuals with high risk habits or jobs, or individuals who live in high risk communities. Proponents also contend that insurance scores actually increase insurance availability in high risk areas because, in the absence of the ability to price accurately, insurers would elect not to offer insurance in those areas at all.

Insurance scores, however, are controversial. Certain insurance score components, like a credit score, have a greater impact on the price quoted for certain consumers. For example, insurers may price personal line policies higher if the policyholder is unmarried, which raises concerns about whether certain life events, such as divorce or death of a spouse, or, as in the case of gay and lesbian couples, the legal inability to marry in many states, should be considered an appropriate basis for increasing the price of mandatory insurance policies. In addition, rating factors like education, occupation, and credit score, or the components of a credit score, may be correlated with race and thus it may appear that a greater percentage of racial minorities pay higher prices.

Personal auto insurance provides an example of how concerns regarding risk classification processes and methodologies can play out. Critics of insurance scoring practices have maintained that risk deter-

minations should rely on factors that have a direct connection with driving ability or capacity. Accordingly, these critics support a number of reforms ranging from prohibiting the use of credit scores to requiring that premiums be based on driving record, miles driven, and driving experience.

Ultimately, insurance scoring or other risk classification systems may be important tools that allow insurers to charge higher rates to individuals who engage in riskier behavior. However, regulators and consumers should better understand the criteria and methodology by which insurers develop a policyholder's risk profile. The technical evolution of insurance pricing has been driven by advances in data mining and technological capability, and responsible use of these techniques that imposes higher prices on truly risky behavior should be permitted. However, simply because data may be available regarding consumers does not mean that any data is relevant to determining the insurance premiums they should pay.

With an ever-expanding universe of personal information available, important questions regarding boundaries or limitations on the use of that personal information should be answered in the context of insurance. Therefore, regulatory policy and practice must clarify that the criteria and methodologies actually used by insurers not rely on impermissible or discriminatory factors. Risk classification factors may be an appropriate subject for binding, uniform federal standards, particularly to the extent that insurance scoring methodologies involve factors that implicate rights secured under federal law.

In addition to developing and articulating standards concerning the proper use of data and methodologies of risk classification, state regulators should develop protocols for oversight of vendors – or insurers if the insurer develops the protocol for its own use – that provide the algorithms and data that render insurance scores and affect eligibility, tier and price of coverage. In most cases, the vendors that sell insurance score products and services to insurers are not subject to oversight by state regulators. The lack of transparency into the development of insurance scores prevents regulators – and the public – from meaningfully evaluating not only a rate but also the process by which that rate has been determined.

Improved regulatory oversight of the insurance score vendors should be a priority for state regulators, including the development and adoption of an appropriate model law that will subject insurance score vendors to licensing and examination standards. In addition, FIO has authority to monitor the affordability and accessibility of non-health insurance products to traditionally underserved communities. In the exercise of this authority, FIO will monitor state regulatory activity in this area and move for federal involvement if reasonable progress is not achieved in the near term. In support of its responsibility to monitor access to affordable insurance to traditionally underserved communities, FIO will study the appropriate boundaries of use of personal information for insurance pricing and coverage purposes.

Box 10: Access of Native Americans to Insurance

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

The United States has a unique legal and political relationship with Indian tribes and Alaska Native entities as provided by the U.S. Constitution, treaties, court decisions, and federal statutes. Generally, state insurance laws and regulation do not apply to policies sold in Indian Country. Regulatory authority, the power to develop insurance law and regulation, and the authority to operate tribally-owned insurance companies remains with Tribal governments. However, the majority of Tribal governments have not established specific insurance regulatory regimes, thereby leaving the responsibility with Tribal courts to determine the acceptable market conduct of an insurer or insurance professional on Tribal lands.

The absence of defined regulatory parameters presents a challenge for insurers considering the sale of conventional insurance products in Indian Country. Insurers point to the lack of a legal and regulatory framework as a reason for not conducting business in Indian Country. Despite the progress some organizations have made to provide access to affordable insurance in Indian Country, there remains a genuine need for additional insurance protection to limit business owners' and individuals' exposure to devastating losses from natural disasters or other unforeseen events, which in turn may hamper economic development. This is an area in which federal action may be warranted.

One possible course for consideration is to facilitate purchase of broader flood coverage. The Department of Homeland Security oversees the National Flood Insurance Program (NFIP), which is administered in part by the Federal Emergency Management Agency (FEMA). To be eligible to purchase flood coverage, FEMA requires that the property be located within a FEMA flood map zone or designated flood zone. However, many Tribal lands are not mapped by FEMA. FEMA estimates that fewer than 90 of the 566 federally recognized Tribes reside on lands mapped by the NFIP and are, therefore, eligible for participation in conventional NFIP coverage.

The Department of Housing and Urban Development (HUD) helped address this coverage gap by recognizing the need for an affordable flood program on tribal lands that have not been mapped. This privately offered policy covers up to \$15,000 in damage for an insured property. In coastal areas, this flood policy pays regardless of whether the insurer has determined the cause of damage to be wind or water. Tribes have encouraged the federal government to facilitate the development of alternative insurance programs by allowing enhanced flexibility in federal programs that would provide more affordable coverage options, including an NFIP partnership with a Native American-owned insurance or risk retention enterprise.

FIO will initiate a consultation with Tribal leaders, including tribally-owned risk pools, and involve relevant federal agencies and state regulators, with the objective of identifying alternative courses of action to improve the accessibility and affordability of insurance on sovereign Tribal lands.

Nonadmitted and Reinsurance Reform Act of 2010

Recommendation: 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.

The Nonadmitted and Reinsurance Reform Act (NRRA) was enacted as part of the Dodd-Frank Act. Part I of the NRRA, which took effect on July 21, 2011, reformed surplus lines insurance by streamlining the collection of taxes for multi-state surplus lines placements.

Surplus lines insurance provides coverage for businesses and consumers for risks that are not adequately insured by insurers licensed to do business in the given states. Surplus lines policies often cover one policyholder for property that the policyholder owns in multiple states. Prior to July 21, 2011, states typically taxed the premium on a pro-rata basis according to the value of the insured risks located in the various states. The various states, however, have different surplus lines tax collection processes and offices, as well as different tax rates. Thus, there was great potential for confusion among producers paying surplus lines taxes for multi-state risks.

The NRRA prohibits any state other than "the home State of an insured" from requiring premium tax payments from nonadmitted insurers. The NRRA permits states voluntarily to "enter into a compact or otherwise establish procedures" for allocating premium taxes for nonadmitted insurance paid to the insured's home state. Absent a compact, states may only collect premium tax on the premium written

in the home state. The NRRA also expresses the intention of Congress that states adopt nationwide uniform requirements, forms, and procedures to provide for the reporting, payment, collection, and allocation of premium taxes for nonadmitted insurance.

As of December 31, 2012, five states and Puerto Rico were participating in the Nonadmitted Insurance Multi-State Agreement (NIMA), which created a central clearinghouse for reporting, collecting, and allocating nonadmitted insurance premium taxes. No other states are operating in a tax allocation agreement. Nine states have entered into the Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT), which would also create a tax payment clearinghouse and an allocation agreement. However, SLIMPACT will not become effective until ten states enter into the compact. Many other states simply enacted legislation authorizing the collection and retention of 100 percent of the nonadmitted insurance premium taxes for which the state is the home state of the insured.

Seven states (three of which entered SLIMPACT and four of which have entered no premium tax allocation agreement) are collecting nonadmitted insurance premium taxes at a pro-rata rate according to the locations of the multi-state risks. Nonetheless, these states are retaining 100 percent of the premium taxes. Finally, some states are taxing 100 percent of nonadmitted insurance premiums, including premiums for risks located in non-U.S. jurisdictions. Some question the legality of such a practice and suggest that it subjects insureds to double taxation.

The NRRA could be a model for insurance regulatory reform because it preserves state regulation but provides incentives for states to act in a manner consistent with federal guidelines. It urges states to simplify and make uniform the regulation of surplus lines insurance in the United States. However, the states have not fulfilled this vision as some states have agreed to share the premium tax collected from surplus lines insurance and others have opted to retain the premium tax applicable to the insurer's home state. A compact seems no more likely than before the NRRA became law. Implementation of the NRRA demonstrates the challenge of facilitating coordinated state action when coordinated action may materially impact state general revenue funds. FIO will continue to monitor state progress on this issue. Further federal action on this issue may be warranted in the near term.

Natural Catastrophes⁷⁶

Recommendation: States should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.⁷⁷

Natural catastrophes can cause severe stress on all aspects of an affected community or region. These events strain P/C insurance markets. With an estimated \$58 billion in insured losses in the U.S. resulting from weather events, 2012 surpassed the average insured losses of \$27 billion from 2000 to 2011.⁷⁸ Large-scale natural catastrophes insured through the private sector strain industry resources, often resulting in higher premium rates for consumers. After significant outlays resulting from a natural catastrophe, insurers typically rebuild capital levels through increases in premiums, which often result in higher prices for consumers.

76 Pursuant to the Biggert-Waters Flood Insurance Reform Act, Pub.L.112-141; 126 Stat. 916 (2012), FIO will submit a report to Congress on a variety of insurance-related natural catastrophe topics.

77 This section does not address terrorism risk or the Terrorism Risk Insurance Act (TRIA), as renewed and set to terminate on December 31, 2014. The President's Working Group on Financial Markets is studying and will issue a report on TRIA.

78 Munich Re, 2012 Natural Catastrophe Year in Review, January 3, 2013, *available at* http://www.munichre-america.com/webinars/2013_01_natcatreview/natcat_webinar_record/player.html2012.

Higher premiums following a catastrophe can limit the affordability and accessibility of conventional insurance to consumers. When insurers raised premiums and curtailed dramatically offers of coverage following Hurricane Andrew in 1992 and after the Northridge earthquake in 1994, states created publicly supported or operated insurance or reinsurance programs to improve accessibility and affordability of property insurance coverage.

In a 2010 report, the GAO reviewed a sample of these public catastrophe programs, many of which have been growing over the last half of the decade.⁷⁹ From 2005-2010, the state insurance program in Mississippi had grown 495 percent, Texas had grown 147 percent, and Florida had grown 146 percent. The GAO found that some state catastrophe programs rely upon risk transfer through the reinsurance markets, while others rely on post-event funding, bonding, and assessments, to pay for incurred losses.

States also approach and design these residual market programs with different objectives. Some state programs encourage broad participation while other state programs attempt to manage participation through eligibility requirements, rates, or through other legislative or market-oriented approaches. Most states do not charge actuarially justified rates to residents seeking to participate in a state residual market program. In particular, the GAO found:

Six of the 10 programs charged rates that did not fully reflect the risk of loss, potentially discouraging private market involvement and mitigation efforts by property owners. However, charging rates that do not fully reflect the risk of loss can also potentially increase broad-based participation in state programs. Officials from 7 of the 10 programs said that they took steps to encourage private market participation, and officials from 9 programs told us that they are implementing or considering ways to encourage mitigation, including providing mitigation credits or attempting to develop a more effective mitigation plan. Officials from most of the programs said they encourage broad participation in their programs; however, a few said they specifically discourage it and instead try to encourage homeowners to purchase insurance from the private market.⁸⁰

The results of state involvement can be mixed and, accordingly, state approaches are evolving. The California Earthquake Authority (Authority) requires insurers writing homeowner policies either to offer earthquake coverage or to join and participate in the Authority. The Authority is privately funded and generally manages its exposure through the purchase of private reinsurance. While earthquake insurance is now available to California property owners, the premium cost appears prohibitive for most. Only approximately 14 percent of California property owners have earthquake insurance, penetration rates roughly the same as before the Northridge earthquake.

Industry critics assert that public insurance programs in some areas exposed to hurricanes may limit or crowd out private market capital. Nevertheless, states with coastal areas exposed to hurricanes have found that public support can improve the accessibility of homeowner insurance. Public sector programs frequently inject public capital into an insurance market at rates with which the private sector cannot compete.

The NFIP provides protection for property owners against losses caused by flooding. Superstorm Sandy illustrates the important role of the NFIP in supplementing coverage available for property owners through the private insurance market. Until 2005 and the devastating losses of Katrina, Rita, and Wilma, premiums collected by the NFIP effectively covered annual losses. Due to the hurricane losses of 2005, though, the NFIP accumulated a deficit in excess of \$18 billion. When Superstorm Sandy hit

79 GAO, *Natural Catastrophe Insurance Coverage Remains a Challenge for State Programs*, GAO-10-568R Natural Catastrophe Insurance Coverage (2010).

80 *Id.* p. 3.

the northeast in October 2012, NFIP owed the U.S. Treasury \$17.8 billion. Due to losses from Sandy, Congress passed legislation increasing the borrowing authority of the NFIP to \$30.4 billion.

The Biggert-Waters Flood Insurance Reform Act of 2012 modifies important provisions of the NFIP. First, premiums paid for NFIP coverage will more closely approximate rates justified by the risk of loss (*i.e.* more actuarially justified). Second, NFIP, for the first time, is authorized to secure reinsurance from the private market at rates and on terms determined to be reasonable and appropriate.⁸¹

At this time, different states are engaged in a variety of approaches that are sufficiently new and varied such that best practices for national adoption should wait until further development and identification of the more successful of these programs. While public policy debates are focused on the relative merits of residual market insurance programs, enhanced property owner mitigation initiatives receive widespread support. The amount of insured loss for a particular natural catastrophe is a function of the density of exposed properties in an area, and the ability of those properties to withstand the effects of the disaster. Effective mitigation strongly enhances the safety of occupants and the durability of property.

Empirical data supports the adoption of statewide building codes to save lives and to reduce the cost of property damage. A study by the Louisiana State University Hurricane Center estimated that stronger building codes would have reduced wind damage from Hurricane Katrina by 80 percent, saving as much as \$8 billion. A more recent report, sponsored by the Federal Alliance for Safe Homes, a non-profit organization focusing on economic resiliency and the role of mitigation in reducing the economic impact of natural disaster, used the uncommonly large number of natural disasters occurring in 2011 to highlight the important role that mitigation and planning have played as different areas recovered from natural disasters.⁸²

While difficult to implement mitigation measures for every building in a catastrophe prone area, states and communities investing in the science of mitigation and exploring ways to reduce losses through construction standards may offer the best opportunity for ensuring access to affordable insurance. Proper construction techniques and materials can save lives and reduce both insured losses and taxpayer burden.

States should identify, adopt, and implement best practices for construction standards, including building codes, to mitigate losses from natural catastrophes. FIO intends to expound at greater length on issues involved with natural catastrophes in the forthcoming report required by the Biggert-Waters National Flood Insurance Reform Act of 2012.

81 42 U.S.C. § 4055(a)(2).

82 "Impact 2011: Examining a Year of Catastrophes through the Lens of Resiliency," December 2011, prepared by Weather Predict Consulting, Inc. for the Federal Alliance for Safe Homes 2011 Annual Meeting, www.flash.org.

V. TAKING ACCOUNT OF REGULATORY REFORM

In June 2009, Treasury published the white paper entitled *Financial Regulatory Reform: A New Foundation*, which articulated six principles by which to measure proposals for insurance regulatory reform:⁸³

1. Effective systemic risk regulation with respect to insurance.
2. Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies.
3. Meaningful and consistent consumer protection for insurance products and practices.
4. Increased national uniformity through either a federal charter or effective action by the states.
5. Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business.
6. Increased international coordination. Improvements to our system of insurance regulation should satisfy existing international frameworks, enhance the international competitiveness of the American insurance industry, and expand opportunities for the insurance industry to export its services.

The Dodd-Frank Act addresses some of these principles directly. For example, the Dodd-Frank Act provides a mechanism for consolidated supervision of insurance firms, or firms with insurance subsidiaries, by empowering the Council to determine that a nonbank financial company shall be supervised by the Federal Reserve if, at least in part, the firm's material financial distress could pose a threat to the financial stability of the United States. If the Council determines that supervision by the Federal Reserve is appropriate, then the firm shall also be subject to enhanced prudential standards. Designation of such firms allows for consolidated supervision of insurers, including corporate affiliates. Similarly, with respect to increased international coordination, Congress empowered FIO to represent the United States on prudential aspects of international insurance matters.

While not all of the six principles are directly addressed by the Dodd-Frank Act, as described more fully in this Report, those topics are the subject of current reform initiatives at both the national and international level. For example, supervisors worldwide are reviewing capital and consolidated supervision regimes independently and multilaterally, including the NAIC and the IAIS. Countries including Mexico, Canada, and China are implementing modernized insurance supervisory regimes. Consumer protection and market regulation also remains the subject of state, national and international attention. A summary of reform efforts with respect to each of the six principles is discussed below.

Systemic Risk Regulation. Title I of the Dodd-Frank Act establishes the Council and charges it with identifying risks to the financial stability of the United States, promoting market discipline, and responding to emerging threats to the stability of the United States financial system. Under Title I, the Council may determine that a nonbank financial company, including an insurer, shall be supervised by the Federal Reserve and shall be subject to prudential standards if the Council concludes that company's material financial distress or activities could pose a threat to the financial stability of the United States. This supervision, together with heightened prudential standards, will better allow regulators to address and mitigate risks to the financial stability of the United States posed by nonbank financial companies.

⁸³ Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, June 2009, at 39.

How To Modernize And Improve The System Of Insurance Regulation In The United States

The Council has three members who specifically have background in or who are involved with oversight of the insurance sector. These members are: (1) a voting member with insurance expertise, who is appointed by the President, with the advice and consent of the Senate; (2) the FIO Director, who is a non-voting member; and (3) a state insurance commissioner, also a non-voting member. This representation provides the Council with significant regulatory experience and knowledge of the insurance industry.

Insurance sector participants and observers argue that traditional insurance business activities do not present the kind of risk that could, in the event of failure, impair the functioning of the U.S. financial markets. This argument seeks to distinguish insurers from traditional financial intermediaries on the ground that insurers by and large do not rely on short-term funding and are not susceptible to runs or liquidity stresses because insurers do not hold liabilities, such as deposits. Ordinarily, a withdrawal from an insurer presupposes the occurrence of an event covered in a policy (*e.g.*, an accident or death). These events are typically uncorrelated (except in the event of mass catastrophes or disasters).

Financial stability concerns arise more often when traditional insurers engage in non-traditional activities, such as derivatives trading, securities lending, or other shadow banking activities, or when they offer products that have features that make them susceptible to runs. Through the Council's authority to determine that nonbank financial companies shall be subject to supervision by the Federal Reserve and enhanced supervision and prudential standards, the orderly liquidation authority with respect to failing firms that could threaten financial stability, and the comprehensive regulation of the derivatives markets, regulatory agencies now have much better tools to address threats to financial stability posed by any particular insurer. Reforms of solvency regulation discussed in this Report, moreover, would further strengthen the supervisors' ability to address risks posed by insurers to financial stability.

Capital Adequacy. As discussed more fully in this Report, capital adequacy standards for insurers are a subject currently being evaluated by the domestic and international insurance regulatory community. State regulators, through the NAIC's SMI initiative and in the EU-U.S. Insurance Project (*see* Box 4), are reviewing state-based RBC standards. Separately, but as a related matter, the IAIS ComFrame initiative will develop a quantitative capital standard for internationally active insurance groups. This Report's recommendations encourage not only further work on this front, but also improved uniformity and oversight across jurisdictions with respect to discretionary practices, more robust regulation of captives and special purpose vehicles, and better oversight of accreditation processes. These additional measures will be important steps toward modernizing capital adequacy standards in insurance regulation.

Meaningful and Consistent Consumer Protection. This Report identifies a number of areas for improving consumer protection. Areas such as producer licensing, product approval, and market conduct examinations are among the areas that have long been considered appropriate for improvement and modernization, particularly through establishment of uniform nationwide standards. This Report touches on these issues, and on others such as risk classification, rate regulation, natural catastrophes, and suitability for customers of annuities products.

National Uniformity. A uniform system of insurance regulation can reduce unnecessary cost and burden. A 2009 study by McKinsey & Co. estimated that regulatory costs added as a result of the current system total \$13 billion annually, \$7.2 billion of which are borne by P/C insurers.⁸⁴ Although many note that the states have taken significant steps towards improvement, the state regulatory system continues to suffer from a lack of uniformity. This Report has recognized uniformity as a central concern regarding the current system of insurance regulation in the United States and, throughout, the analysis and recommendations point to concrete measures to improve uniformity with respect to both solvency and market conduct regulation.

84 McKinsey & Company, April 2009, *supra*.

Consolidated Supervision. The Dodd-Frank Act introduces consolidated supervision of insurers in two different ways. First, to the extent an insurer or group is designated by the Council under Title I, its financial activities will be regulated as a consolidated entity. Second, in Title III, the Dodd-Frank Act eliminated OTS and turned oversight of federally chartered thrifts to the OCC, and made the Federal Reserve Board the supervisor of thrift holding companies at the consolidated level, including those with insurance subsidiaries or affiliates.

Nevertheless, a substantial number of insurers are part of larger corporate groups that are not covered by either Title I or Title III of the Dodd-Frank Act. Accordingly, determining how best to introduce consolidated supervision has been an agenda item both for state regulators and international supervisors. Domestic efforts have met with mixed results, in part reflecting the inherent limits of state jurisdiction. This Report supports the state regulators' efforts to improve consolidated supervision practices. The Report also provides recommendations for the short term, including enhancement of supervisory colleges. Particularly in light of the global nature of the activities of large insurance firms, this is an important area for continuing work.

International Coordination. In Title V, the Dodd-Frank Act vests FIO with authority to coordinate and develop federal policy on prudential aspects of international insurance matters and to represent the United States at the IAIS. FIO today actively represents the United States in international fora, involvement that will continue to expand. At the IAIS, FIO serves on the Executive and Financial Stability Committees, and serves as Chair of the Technical Committee. FIO also serves on several of the IAIS subcommittees. FIO also consults and coordinates with state regulators and other federal agencies in connection with these activities. For example, FIO's collaboration with state regulators has brought the EU-U.S. Insurance Project to a defined path forward. Insurers operating on both sides of the Atlantic have increasing certainty about the impact of regulatory developments, and supervisors in both jurisdictions have heightened awareness and understanding of the other's regulatory regime.

Efforts at international coordination must also continue apace because many aspects of the insurance sector are increasingly global and standard-setting activities will deeply affect oversight of the industry in both developed and emerging markets around the world. Moreover, inattention to global matters and discord among jurisdictions could lead to competitive disadvantages for U.S. firms. Accordingly, this Report contains recommendations specifically tailored to cross-border matters, such as reinsurance, which have important competitive and solvency implications.

VI. CONCLUSION

It is not enough to say that the U.S. system of insurance regulation should be improved and modernized – this is true in every regulatory framework. Financial services evolve with great pace, and regulators of every sector are challenged to remain current, to foster competitive markets, and to protect consumers. Insurance does not differ from banking, securities and commodities in this respect – the insurance sector and its national and international markets are in constant flux.

This Report has identified some targeted and broad areas for which reform of the state-based system of insurance regulation is appropriate. Any reform proposal must also account for the threshold issue of how that reform will be achieved. Notwithstanding a decades-long debate about whether insurance should be regulated at the state or federal level, for the benefit of U.S.-based insurers and consumers, the debate is best reframed as one in which the question is where federal involvement is warranted, not whether federal regulation should completely displace state-based regulation.

Insurance markets are increasingly global, and any structural reform proposal should be premised on objective analyses of current regulation, identification of subject matter areas genuinely in need of reform, and the inherent legal and practical limits of the states. While this Report does not propose a recommendation for every conceivable shortcoming of the insurance industry and its regulatory framework, it sheds light on areas in need of prompt modernization and improvement.

With respect to prudential oversight, state-based regulation has largely evolved with the recognition that the ability of an insurer to pay a claim is the bedrock on which the U.S. insurance market is based. While not beyond reproach, and in need of specific reforms identified in this Report, state regulators have developed a system of entity-specific financial oversight that satisfies this most fundamental regulatory objective. States need to improve prudential oversight of insurers, but are working in that direction. FIO will monitor state regulatory developments, including those called for in this Report, and will present options for federal involvement as such options become necessary.

Any system with 56 independent jurisdictions is inherently limited in its ability to regulate uniformly and efficiently. This remains true for the state-based system of insurance regulation in the United States. The impact of this lack of uniformity is felt acutely in both prudential matters and in certain areas of marketplace oversight. To address the inefficiencies and lack of uniformity in the state regulatory system, federal involvement will be necessary. The *status quo*, or a state-only solution, will not resolve the problems of inefficiency, redundancy, or lack of uniformity, or adequately address issues of national interest. This Report describes some of those areas where federal standards and intervention may be most beneficial.

Working with all aspects of the insurance sector, including state regulators and policymakers, consumers and industry, FIO will recommend additional improvements to the U.S. system of insurance regulation that best integrate the interests of U.S. insurers and consumers. Whether, and to what extent, those improvements will require federal involvement will often depend upon the subject matter, circumstances, and ability and willingness of the states to resolve the underlying issue.