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Toward Regulatory Efficiency and Modernization — ACLI Explores Optional Federal Chartering for Life Insurers and Life Reinsurers

by Monica M. Hainer

Both industry and regulators alike have recognized the need for overhauling the present system of life insurance regulation. More than two years ago, the American Council of Life Insurers (ACLI) undertook a thorough review of life insurance regulation; the review acquired added urgency with the passage of the Gramm-Leach-Bliley Financial Services Modernization Act in November 1999. Resulting analyses revealed that life insurance regulation has not kept pace with rapid changes in the financial services marketplace and hinders life insurers' abilities to effectively serve the needs of consumers.



Today, life insurers compete not only with one another but also with banks and securities firms. At the same time, these

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Joe Athlete vs. Joe Average: Who's The Safer Mortality Bet?

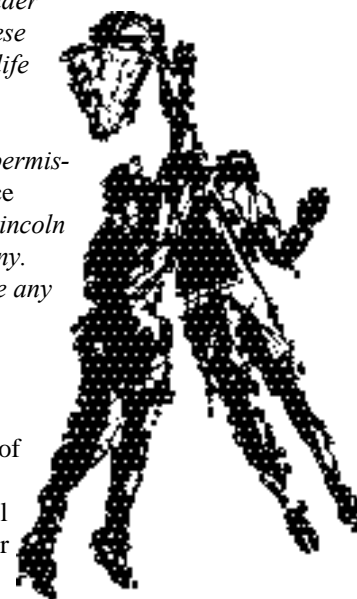
by C. Allen Pinkham

Editor's Note: The misbehavior of professional athletes, from drug abuse to car crashes, surfaces constantly in headlines across the country. It's no wonder insurers take a dim view of these "bad boys" when it comes to life policies.

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When Bobby Phillips of the Charlotte Hornets basketball team died earlier this year after a high-speed race in his Porsche with another player, some observers commented that it was just another example of the "bad boy" conduct to which many professional athletes seem especially prone. "There are so many incidents," reported NBC on May 23, "that some say they make America's sport pages read like a police blotter."

With the media spotlight often on drug and alcohol abuse, violence, and car crashes (like the one that took Phillips' life)



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competitors are regulated under more streamlined and centralized systems, allowing them to more quickly introduce new products to a national market.

ACLI has concluded that for the life insurance business to remain viable, fundamental changes to the insurance regulatory system need to be implemented as expeditiously as possible. Of equal importance, ACLI also has concluded that any such changes must preserve effective solvency oversight of life insurance companies and assure that consumer protection remains paramount.

ACLI is diligently working to improve the regulatory system for life insurers and

has instituted a dual-track approach. On track one, which entails significant efforts to improve the current state regulatory system, ACLI is working with the National Association of Insurance Commissioners (NAIC) by providing detailed proposals in areas both groups have identified as priorities — producer licensing, speed-to-market, and market conduct. At the same time, on track two, ACLI is exploring the feasibility and desirability of optional federal chartering



(OFC) for life insurers. The working draft of ACLI's OFC proposal is based on the dual regulatory system presently found in commercial banking, thrift, and credit union businesses.

ACLI's working draft would establish an Optional Federal Charter (OFC) for the regulation of life insurance and life reinsurance companies. It creates the National Insurer Act and the National Insurer Solvency Act and establishes an Office of National

Insurers in the Department of the Treasury. Many of the specific regulatory concepts found in the OFC proposal are based on insurance laws and consumer protections currently found in state insurance statutes. This draft reflects only one area of ACLI's work to reform and modernize the regulation of the life insurance industry. The majority of the ACLI's resources focus on reforming the state-based regulatory system, and this approach will continue.

The working draft envisions the establishment of an optional federal chartering system intended to provide strong, efficient, and effective insurance regulation. In no way does the proposal suggest deregulation of the life insurance business. By contrast, it proposes a level of regulatory oversight and scrutiny of life insurance companies that is at least equal to that which presently exists in the states. Its objective is to create a strong regulatory system, through a single regulator, which can be administered efficiently. The proposal achieves that goal while ensuring two items of paramount importance: effective solvency regulation and appropriate consumer protections.

The proposal assumes that life insurance companies will choose to be either federally or state regulated based on the particular needs and circumstances of their operations. Whatever their choice, ACLI believes that the regulation of life insurance companies will remain at a

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high standard and the efficiencies resulting from an insurer's choice of regulatory scheme will benefit insurance consumers.

Given the fact that life reinsurance is one of the most complex but fundamentally important components of a smoothly functioning life insurance industry, ACLI called on a team of experts from within its membership to draft the reinsurance portions of the OFC. When the reinsurance team began crafting the reinsurance proposal, they carefully considered the changing landscape for the life reinsurance industry. Facing the same competitive challenges as primary insurers and increased client demand for more sophisticated risk transfer products, ACLI's reinsurance team concluded that reinsurers also need a regulatory apparatus that is dynamic and efficient in order to continue to compete effectively in the risk transfer marketplace. The OFC reinsurance section is designed to assist life reinsurers with staying competitive and broadening the range of approaches and products available to the life insurance industry.

The reinsurance team identified four main reasons for the need for regulatory change:

- Life reinsurers' core business is international in scope, generally more so than the direct market. A random poll of ACLI member company reinsurers revealed that international business is a rapidly expanding part of their overall business and international growth is a significant item in their strategic plans. Also, as more and more direct insurers seek to expand their markets internationally, life reinsurers are considered a vital component in those companies' strategies.
- Life reinsurers are competing directly against reinsurers from countries with less distinction between insurers and commercial banks than the U.S. Reinsurers, particularly those from the European Union, have significant advantages over U.S. reinsurers because their regulatory environment facilitates greater market responsiveness.

- Market demand by U.S. life insurers for nonproportional and nontraditional reinsurance products, which the current insurance regulatory framework does not accommodate, is growing significantly.
- Life reinsurers are now competing against financial services institutions selling risk transfer products that function like reinsurance but are not subject to the same capital and regulatory burdens. The alternative risk transfer (ART) market is not large now, but it is growing rapidly. Undoubtedly, new ART products will emerge, and the entire ART market will grow exponentially as capital market investors become more familiar with insurance risk.

Although all states have adopted substantially similar versions of the basic NAIC models on life reinsurance, interpretation and application of those laws varies significantly. Lack of regulatory uniformity has been the life reinsurance community's single-most important criticism of state regulation. Additionally, the current life reinsurance regulatory regime does not accommodate the post- Gramm-Leach-Bliley environment where functionally similar risk transfer products are being regulated differently, depending solely upon the charters of the contracting entities (e.g., reinsurers and banks) rather than upon the actual risk characteristics of the business being assumed. As a result, domestic laws and rules regulating reinsurance need to be modernized in order to be flexible enough to oversee a rapidly changing market with new market players and new kinds of risk transfer products.

The reinsurance regulatory solution offered in the OFC working draft is based on four fundamental underpinnings. They are:

- Uniformity of law and regulation to foster regulatory predictability and transparency for ceding companies and reinsurers and encourage efficiency and best practices in the industry;

- A dynamic regulatory system that allows commercial responsiveness to evolving business needs for sophisticated risk transfer mechanisms;
- A level playing field among financial entities selling functionally equivalent products; and
- A system that supports and fosters the international scope of the business.

The ACLI has not decided whether to seek introduction of optional federal chartering legislation in Congress. Should the ACLI decide to pursue an Optional Federal Charter, three principal improvements in the regulation of the business of life reinsurance could occur. The OFC could expand opportunities and choices in reinsurance products and providers for ceding companies, make reinsurance transactions more efficient, and foster growth, greater competition, and more prudent financial management in the reinsurance industry.

The ACLI is currently in the process of thoroughly vetting the draft OFC proposal with its membership, regulators and legislators, leading consumer groups, and other important organizations. Their input will be crucial in evaluating whether ACLI should pursue an Optional Federal Charter. To the extent that readers of this article work for companies who have membership in the ACLI, your review of the draft documents and your substantive feedback are welcome. Materials are available on ACLI's Web site, www.acli.com.

Monica M. Hainer, FSA, MAAA, is president and chief executive officer of London Life Reinsurance Company. Monica is a long-time member of the American Council of Life Insurers Reinsurance Committee and currently is serving the first year of a two-year term as Committee chair. Monica also is a member of ACLI's Board of Directors and serves on the Board-level committee responsible for overseeing the Optional Federal Charter project. Additionally, Monica is a past chairperson of the Society of Actuaries Reinsurance Section.