



SOCIETY OF ACTUARIES

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# Update on Regulatory Developments

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## OVERVIEW

Starting with this issue, we will report quarterly on regulatory developments in the United States and internationally. We will be following developments at the National Association of Insurance Commissioners (NAIC), the International Association of Insurance Supervisors (IAIS), as well as other groups who may get involved in group supervision, and discuss those that may be important to members of the Financial Reporting Section.

The last quarter of 2013 was a big one for regulatory developments, with the much-awaited report (commissioned in the Dodd-Frank Act) on whether the United States should have federal or state regulation of insurance. The answer was: Let's keep the state system, making some changes to improve some of its shortcomings, and add federal regulation only in limited areas where it makes sense. Proponents of federal regulation will be disappointed, but by all accounts, the majority appreciates the restrained approach taken by the Federal Insurance Office (FIO).

On the NAIC side, by contrast, the fall meeting of the Life Actuarial Task Force (LATF) was chock-full of presentations representing countless hours of work and forward progress, but there was little that was new or different. Even discussions of principle-based reserves (PBR) showed no surprises, just a sense of the enormous amount of work ahead for regulators (to say nothing of the industry) to meet the 2016 date. 2016 remains the target date, but a few times the words "or 2017" were heard. Watch this space.

Finally, on the international side, there is ongoing forward progress on international capital standards and the Insurance Core Principles, as well as an interesting report on longevity risk transfer.

## FIO REPORT ON THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES

On Dec. 12, 2013, the FIO issued its report titled "How to Modernize and Improve the System of Insurance Regulation in the United States" (the Federal Insurance Modernization Report, or "the Report").<sup>1</sup>

This article focuses on the role of the FIO and its recommendations for near-term improvement to the insurance regulatory system in the United States. Regulatory items not related to solvency and financial reporting (e.g., market conduct and the mechanics of dealing with insolvent insurers) are touched upon at the most cursory level only.

### Key Takeaways

First and foremost, the FIO does not recommend that state insurance regulators be replaced wholesale by a single federal regulator. The report prefers a more disjunctive two-part approach. One part is identifying areas where federal intervention is warranted. The second is to recommend short-term changes to the current state-based regulatory system. Cooperation between states, and between countries, to pool knowledge and resources across states and across countries, is a recurring theme.

### What the FIO Does

The FIO, formed in July 2010 as part of the Dodd-Frank act, was given the following authorities:

- 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 U.S. financial system;
- Monitor the extent to which traditionally underserved communities and consumers, minorities, and low/moderate-income persons have access to affordable insurance products for all lines except health insurance;
- Recommend which insurers, including affiliates, should be designated as non-bank financial companies to be supervised by the Federal Reserve;
- Assist the Treasury Department in administering the Terrorism Insurance Program established in 2002;
- Coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the United States in the IAIS and assisting the secretary in negotiating covered agreements ;
- Determine whether state insurance measures are preempted by covered agreements<sup>2</sup>;



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- Consult with the state insurance regulators regarding insurance matters of national importance and prudential insurance matters of international importance; and
- Perform other related duties and authorities as assigned.
- The degree of national/federal interest for that area; and
- The nexus<sup>3</sup> of the issues and the firms with the global marketplace.

The Dodd-Frank Act also explicitly required the FIO 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. The Federal Insurance Modernization Report answers that requirement.

The report reiterated the limitations of the current state-based insurance regulation in the United States:

- Higher cost of regulation per dollar of premium;
- Uniformity and consistency issues; and
- Lack of coverage of non-U.S. players (especially in reinsurance).

It also recognized the local nature of some insurance products (not necessarily relevant to life or health insurance), where state regulation would be more appropriate.

The report concludes that the proper question is not whether there should be federal or state regulation, and that the better question is whether there are areas in which federal involvement is warranted, and, if so, which areas. It goes on to say that the necessity for federal involvement in any area should be based on:

- The ability of the states to regulate that area effectively;
- The ability of the states to regulate that area with uniformity;

If the answer is that federal involvement is warranted, the next question is what form that involvement should take. Some possibilities are:

- Direct regulation;
- Standard setting;
- Operating a program to support or replace a failed insurance market.

***Specific, Short-Term Reform Recommendations for the States***

Based on the above framework, the report recommends the following to improve and modernize the U.S. system of insurance regulation:

1. For material solvency oversight decisions, a process where the appropriate state regulator must obtain the consent of regulators from other states in which the subject insurer operates.
2. An independent third-party review mechanism for the NAIC Financial Regulation Standards Accreditation Program.
3. A uniform and transparent oversight regime for the transfer of risk to reinsurance captives.
4. Convergence of state oversight and capital adequacy regimes to best practices and uniformity.
5. Moving forward cautiously with PBR, with (a) consistent, binding guidelines for accounting and solvency requirements, and (b) uniform guidelines and sufficient resources at the state level to ensure adequate supervisory review of PBR.

6. Development of state corporate governance principles for corporate directors and officers, appropriate to the size and complexity of the insurer.
7. Continue to develop an approach to group supervision to address the shortcomings of solo entity supervision. In particular, consider the concept of supervisory colleges.<sup>4</sup>

The report goes on to recommend uniform approaches to (a) state guarantee maximum benefits, and (b) the administration of estates of failed companies, especially the settlement of qualified contracts with counterparties. It also makes a number of recommendations for market conduct issues.

#### **Recommended Areas for Direct Federal Involvement**

The report lists a number of areas where federal involvement is recommended, or may be recommended near term. Items 2 and 3 are relevant to solvency regulation for the life and health insurance industries.

1. Develop federal standards for mortgage insurer oversight.
2. Pursue a covered agreement on reinsurance collateral requirements based on the NAIC Credit for Reinsurance Model Law and Regulation.
3. Engage in supervisory colleges to monitor large national and internationally active reinsurers.
4. The National Association of Registered Agents and Brokers (NARAB) Reform Act should be adopted and the FIO should be charged with monitoring its implementation.
5. Develop personal auto insurance policies for U.S. military personnel enforceable across state lines.
6. Establish pilot programs for rate regulation that maximize the number of insurers offering personal lines products.
7. Report on the manner in which personal information is used for insurance pricing and coverage.
8. Identify ways to increase access and affordability of insurance to Native Americans.
9. Monitor the simplification of surplus line tax collection; determine if federal action may be warranted.

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#### **Other Sections of the Report**

There are four other sections to the report:

- A history of U.S. insurance industry regulation, including the financial crisis, AIG, government support for the industry, and lessons learned.
- A discussion of prudential oversight—the entire framework of capital requirements, accounting standards, investment portfolio limitations, practices to promote the safety and soundness of insurers, state guaranty funds, and the process for resolving insurer insolvencies. This section also serves as a “basis for conclusions,” showing the analysis that led to the recommendations and conclusions.
- A discussion of marketplace oversight: consumer protection and access to insurance.
- A conclusion.

#### **LATF MEETING AT THE NAIC FALL MEETING, WASHINGTON, D.C., DEC. 13, 2013**

We report briefly here on new developments at this meeting. Briefly, because little was truly new; there was, however, much forward progress on ongoing projects, albeit without landmarks or significant developments.

#### **Specific Developments**

1. Mary Bahna-Nolan (AAA) reported that a slight delay was expected for the 2014 VBT mortality table, as there is some discomfort with the slope and smoker/nonsmoker relationships in the current data.
2. Alan Routhenstein (AAA) reported that an updated table of spreads over Treasuries had been developed for the Valuation Manual. A motion to expose these was passed.

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3. John Bruins (ACLI) requested a small company exemption for PBR, citing the sizable resources required to perform the required calculations. Many regulators voiced approval in principle, but expressed concern about the lack of specificity in how small a company has to be in order to be exempted. ACLI agreed to come back with more precise definitions of what constitutes a small company.

#### ***Items Moving Along, with No Significant Items to Report This Meeting***

- Actuarial Opinion and Memorandum Regulation update
- Accreditation Standards (a motion that non-forfeiture is not a standard was passed)
- AG 33 non-elective incidence assumptions
- Annuity Reserve Working Group
- Kansas Field Tests for VM-22(A)
- Non-Forfeiture Working Group
- Experience Studies (Medical Information Bureau report exposed)
- Joint Qualified Actuary Working Group
- C3 Phase II Working Group
- Contingent Deferred Annuity Subgroup
- Amendment proposals to AG 38

## **INTERNATIONAL DEVELOPMENTS**

The IAIS had a number of developments in the fourth quarter of 2013:

- On Oct. 16, 2013, the IAIS announced a commitment to developing a risk-based, group-wide, global insurance capital standard (ICS) by 2016, as part of its Common Framework (ComFrame). The first step was the exposure of Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SII). Written comments on the BCR exposure draft have been requested by Feb. 3, 2014. A second version, followed by a second round of public consultation, is due in the summer of 2014.

- In December 2013, the Joint Forum of Basel Committee on Banking Supervision issued its report titled “Longevity Risk Transfer Markets: Market Structure, Growth Drivers and Impediments, and Potential Risks.” This report<sup>5</sup> discusses the three major types of transactions for transferring longevity risk, and the regulatory considerations, including assessing risk-bearing capacity, tail risk, and regulatory arbitrage. This is an excellent read for life insurers, annuity writers, pension plans, and even individuals.
- On Oct. 18, 2013, the IAIS adopted a common implementation framework (CIF). This is a procedural step toward getting uniformity among member regulators in meeting the Insurance Core Principles (ICPs), the globally accepted requirements in insurance regulation. ■

### **ENDNOTES**

<sup>1</sup> The full report can be found at <http://www.treasury.gov/initiatives/fio/reports-and-notice/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf>.

<sup>2</sup> A covered agreement is a memorandum of understanding between regulators of different countries to cover matters regarding large, internationally active insurance groups. Dodd-Frank has a covered agreement provision that broadly defines prudential supervision matters that could be subject to such an agreement.

<sup>3</sup> Merriam-Webster defines nexus as a connection or a series of connections. One interpretation is that the facts and circumstances of both the issue and the insurer should inform the decision.

<sup>4</sup> Supervisory colleges are meetings of insurance regulators in different jurisdictions where the topic of discussion is regulatory oversight of one specific insurance group that writes significant amounts of insurance in many jurisdictions (see NAIC Center for Insurance Policy and Research, July 2012 newsletter). The IAIS is seeking to improve the operation and efficiency of supervisory colleges globally, as part of their Common Framework Project (ComFrame).

<sup>5</sup> The report is available on the Bank for International Settlements website ([www.bis.org](http://www.bis.org)) and the online version is numbered ISBN 92-9197-966-X.



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