

FIO FOCUS

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Devoted to exploring the progress of the modernization of the insurance industry, FIO Focus provides information and insights about the organizations and issues that are driving change and influencing the future of the industry.

The Federal Insurance Office (FIO) released its long-awaited report, [“How to Modernize and Improve the System of Insurance Regulation in the United States”](#) (Report) on December 12, 2013. In its Report, the FIO acknowledges the work of state regulators, both historically and on current regulatory reform efforts, but repeatedly notes the lack of uniformity and perceived limitations inherent in a state based system.

The Report addresses high-level issues such as international regulatory coordination and subjects traditionally left to states, including rate regulation. It contains several specific recommendations for state regulators, many of which the FIO intends to monitor. With respect to some of those recommendations, the FIO cautions that federal standards and/or oversight may be warranted should states fail to act. In a couple of instances, the FIO appears to insert itself into a regulatory role.

As the FIO examines various areas ripe for regulatory reform, it recognizes arguments generally asserted by those in favor of the current state based system and contrasts them with proponents of modernizing regulation through federal involvement. The Report is premised on the concept that the U.S. system of insurance regulation can be modernized and improved through a combination of reforms to the current regulatory system and actions by the federal government. There is no express recommendation for direct federal regulation.

Areas Identified for Direct Federal Involvement in Regulation

In its Report, the FIO makes nine specific recommendations regarding areas for direct federal government involvement in the regulation of insurance. Perhaps most controversially, the Report recommends:

- Federal standards and oversight for **mortgage insurers** be developed and implemented. The Report contends that robust national solvency and business practice standards for mortgage insurers will help foster greater confidence in the solvency and performance of housing finance as the U.S. continues to recover from the financial crisis.
- The U.S. Department of the Treasury and the United States Trade Representative (USTR) pursue a “covered agreement” for **reinsurance collateral requirements** based on the National Association of Insurance Commissioners (NAIC) Credit for Reinsurance Model Law and Regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) authorizes the FIO and USTR to negotiate and enter “covered agreements” where necessary to impose uniformity on a prudential insurance matter of national interest. The Report notes it is unlikely that the Model Law and Regulation will be applied uniformly.
- The FIO engage in **supervisory colleges** to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers. The Report suggests that information made available to the FIO through involvement in supervisory colleges would be highly significant to its explicit statutory role to monitor the financial stability of the insurance industry.

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With respect to specific legislative issues on the federal level, the Report recommends:

- Adoption of the National Association of Registered Agents and Brokers Reform Act of 2013 (**NARAB II**) and that FIO monitor its implementation. This recommendation addresses the continuing lack of uniformity in producer licensing requirements despite the Gramm-Leach-Bliley Act and the widespread, but incomplete, adoption of the NAIC Producer Licensing Model Act.
- The FIO continue to monitor state progress on implementation of the Nonadmitted and Reinsurance Reform Act of 2010 (**NRRRA**) of Dodd-Frank, which requires states to simplify the collection of surplus lines taxes and determine whether federal action may be warranted in the near term. The Report notes that the NRRRA “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... However, the states have not fulfilled this vision...”

Two recommendations relate to personal lines products. The Report indicates that the FIO will:

- Convene with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering **personal lines products**.
- 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. The FIO desires to act in this regard as active duty members are often required to transfer across state lines to different bases in the U.S., which may necessitate obtaining new auto policies following each transfer.

In other areas for federal involvement in regulation, the Report states that the FIO will:

- Study and report on the manner in which **personal information** is used for insurance pricing and coverage purposes, and monitor state activity to improve oversight of insurance score vendors. The Report notes that “[r]isk 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.”
- Consult with Tribal leaders to identify alternatives to improve the **accessibility and affordability** of insurance on sovereign Native American and Tribal lands.

Areas of Near-Term Reform for States

The FIO’s Report makes 18 short-term recommendations for actions by the states to modernize and improve the U.S. system of insurance regulation. These recommendations fall into three categories: (1) capital adequacy and safety/soundness; (2) reform of insurer resolution practices; and (3) marketplace regulation.

Capital Adequacy and Safety/Soundness

- For material **solvency oversight decisions of a discretionary nature**, states should develop and implement a process that obligates the appropriate state [domestic] regulator to first obtain the consent of regulators from other states in which the subject insurer operates. The Report states this would reduce the variations that result from discretionary regulatory practices and decisions.
- To improve consistency of solvency oversight, states should establish an independent, third-party review mechanism for the NAIC Financial Regulation Standards **Accreditation** Program. The Report notes that state regulators often consult with the NAIC’s legal staff about adoption of model laws, the same staff that determines whether states have complied with requirements to adopt model laws. To improve the reliability and bolster the credibility of the Accreditation Program, the Report suggests an independent review and audit that would provide a perspective on whether there is uniform adoption and implementation of capital rules and other accreditation standards.
- States should develop a uniform and transparent solvency oversight regime for the transfer of risk to **reinsurance captives**. According to the Report, this should include transparency of the liabilities transferred to reinsurance captives and the nature of the assets that support a reinsurance captive’s financial status. Subject to limitations on the disclosure of legitimately proprietary information, these transactions should be disclosed in the financial statements of the ceding insurer.

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- State based **solvency oversight and capital adequacy regimes** should converge toward best practices and uniform standards. The Report recognizes states' efforts to develop a risk assessment regime, including Own Risk Solvency Assessment (**ORSA**) requirements. However, the Report questions whether state regulators have sufficient resources and skills to review these complex self-assessments. Any solvency oversight and capital adequacy principles should be consistent with international developments, including best practices, standards and principles that are developed through international consensus.
- States should move forward cautiously with the implementation of principles-based reserving (**PBR**) 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 PBR. The Report indicates that states should develop standards for overseeing the vendors upon whom regulators will rely for technical expertise and additional resources.
- 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. The basis for this recommendation is that although state regulators conduct fitness reviews, there are variations in how they are conducted and there is no NAIC model law on corporate governance standards.
- 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. The Report recognizes advances states have taken with respect to group supervision, but also points to the state-based regulatory structure's lack of consolidated supervision.
- State regulators should build toward effective group supervision by continued attention to **supervisory colleges**. Noting the states' "good faith efforts" with respect to the colleges, the Report provides that they are "an important means of addressing the conduct of group supervision in the intermediate term," but are not a substitute for consolidated supervision.

Reform of Insurer Resolution Practices

- 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**.
- 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

- States should assess whether or in what manner **marital status** is an appropriate underwriting or rating consideration. This recommendation was prompted by recent developments at the state and federal levels regarding the treatment of same-sex spouses, including the Supreme Court's decision concerning the Defense of Marriage Act.
- 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. The Report recommends that states with higher consumer protection standards than the IIPRC be permitted to keep them, but member states prohibit insurers from opting into less restrictive standards by filing products directly with states.
- In order to fairly protect consumers in all parts of the U.S., every state should adopt and enforce the NAIC Suitability in **Annuities** Transactions Model Regulation. The Report reasons that the suitability of an annuity purchase should not depend upon the state in which the consumer resides.

- States should reform **market conduct** examination and oversight practices and: (1) require state regulators to perform market conduct examinations consistent with the NAIC 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. These recommendations arise from the industry's criticism of state regulators for failing to adequately coordinate market conduct examinations, resulting in duplicative examinations of an insurer on a similar issue. The Report notes that coordination is "essential to modernization."
- States should monitor the impact of different **rate regulation** regimes (e.g., prior approval, use and file, file and use, open market) on various markets in order to identify rate-related regulatory practices that best foster competitive markets for personal lines insurance consumers. The Report advocates for this plan of action because of empirical studies suggesting rate regulation, particularly in auto and homeowners insurance, may adversely impact market supply resulting in higher prices and an increase in the market share of the residual market.
- States should develop standards for the appropriate use of data for the pricing of personal lines insurance. This recommendation corresponds with the FIO's commitment to study and report on the manner in which **personal information** is used for pricing and coverage purposes.
- States should extend regulatory oversight to vendors that provide **insurance score products** to insurers. The Report indicates it will monitor this activity and move for federal involvement if there is no reasonable progress.
- States should identify, adopt and implement best practices to mitigate losses from **natural catastrophes**. The Report acknowledges that it may take time for best practices to be developed as states are engaged in evaluating a variety of new approaches. The FIO will provide more information on natural catastrophes in a report required by the Biggert-Waters Flood Insurance Reform Act of 2012.

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