Regulatory brief

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Insurers: Is federal regulation coming?

Overview

After much anticipation, on December 12, 2013, the Federal Insurance Office ("FIO") released its report on modernizing the system of US insurance regulation.[1] The report is published under Dodd-Frank Title V's mandate, and provides FIO's view on the benefits that potential federal regulation can bring to the insurance regulatory landscape. While the release of this report satisfies the FIO's legislative mandate, we do not expect the report to lead to substantial changes in the insurance regulatory environment any time soon.

The report discusses state regulation's "inefficiencies and lack of uniformity" with the understanding that "federal regulation should [not] completely displace state-based regulation." It concludes that the overall determination of federal involvement in insurance regulation is a matter for congressional action. Given the existing political environment, we view it as unlikely that federal regulatory authority will be expanded beyond its current boundaries in the near term.

This view is further supported by recent regulatory developments. The designation of AIG, Prudential, and GE Capital as systemically important nonbank financial institutions[2] shows that federal oversight can be exercised without significantly changing the state insurance regulatory system. These designations also serve as a learning opportunity for the Federal Reserve (which is more familiar with banks) to understand the intricacies of the insurance business model, so going forward the Federal Reserve can more accurately evaluate insurance companies' operations, their ability to withstand idiosyncratic shocks, and their risk of systemically important failure.

This **Financial Services Regulatory Brief** provides (a) highlights from the report regarding the insurance industry's key regulatory concerns and FIO recommendations, and (b) our view of next steps for insurance companies. We will cover more specific areas from the report in future regulatory briefs.

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[1] See *How to Modernize and Improve the System of Insurance Regulation in the United States*, Federal Insurance Office (December 2013).

[2] See PwC's *Financial Service Regulatory Briefs*, *Systemically important insurers: Global follows US lead* (July 2013), and *Nonbank SIFIs: FSOC proposes initial designations – more names to follow* (June 2013).

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FIO's key regulatory concerns

The FIO report recommends ways to facilitate interaction between US insurance regulators and their international counterparts (including regional regulators such as the EU, and international standard setters like the International Association of Insurance Supervisors). This is an area which has challenged state regulators and their coordinating body, the National Association of Insurance Commissioners ("NAIC"). State regulators have not been represented through a "single voice," so NAIC often has limited authority to speak on a global level given the diversity of state interests and views. As a way to begin to address this issue, the FIO recommends more uniform national standards in areas such as mortgage insurance, reinsurance, and commercial line products.

The report also summarizes concerns pertaining to inefficiencies, inconsistencies, and gaps within the state regulatory framework. It makes 27 recommendations, 18 of which would, according to the FIO, sufficiently address the underlying issues without the need for federal involvement. Among those 18, the key themes are:

- *Capital Adequacy, and Safety and Soundness*: The report does not fully acknowledge the efficacy of the current system in supervising insurers through the crisis, and stops short of highlighting the relative rarity of insurer insolvencies. Rather, it discusses where state regulators' discretion should no longer be exploited for regulatory arbitrage and regulatory capture.
- *Reform of Insurer Resolution Practices:* The report highlights the importance of adopting a uniform approach to the resolution of insolvent insurers. For example, the report suggests that current regulations do not fully protect counterparties during the closing out and netting of qualified financial contracts ("QFC"). Without consistent regulations, state regulators may overlook ways to reduce counterparty interconnectedness.

  Additional recommendations promote transparency in resolution practices, particularly regarding financial reporting by insolvent insurers and certain disclosures by receivers (and recovery rules for guaranty funds). The current state system has uneven thresholds and triggers, which advantage or disadvantage consumers solely based on their state of residence.
- *Marketplace Regulations:* The report discusses market and consumer concerns. It recommends greater consistency and coordination in market conduct examinations, and adoption of annuity suitability regulations by all states. Additionally, several recommendations address elements of insurance rating and underwriting programs, such as the use of marital status, the use of credit score, and regulatory oversight over insurance score providers.

What are the next steps for insurers?

It is important for insurers to monitor the activities of the FIO and other upcoming studies (covering such topics as monitoring of financial stability, rate regulation, and the use of personal information). In our view, the FIO's role on the international stage will be essential in presenting a "single voice" for the US, particularly as greater efforts to modernize insurance regulation are introduced around the world.

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