

# CLIENT UPDATE

## FIO REPORT ON THE MODERNIZATION OF INSURANCE REGULATION

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### *Introduction*

On Thursday, December 12, 2013, the Department of the Treasury's Federal Insurance Office ("FIO") published *How to Modernize and Improve the System of Insurance Regulation in the United States*.<sup>1</sup> The report was required by Title V of the Dodd-Frank Act,<sup>2</sup> which required 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". In the report, FIO asserts the need for meaningful federal involvement:

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.

In mandating the report, Congress highlighted six considerations for FIO that parallel FIO's general statutory mandates – systemic risk; capital standards; consumer protection; national uniformity; consolidated regulation; and international coordination – as well as

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<sup>1</sup> See link at <http://www.treasury.gov/initiatives/fio/reports-and-notice/Pages/default.aspx>

<sup>2</sup> 31 U.S.C. Section 313.

seven additional factors, including the costs and benefits of federal insurance regulation; the effect that international developments might have on federal regulation; and the consequences of subjecting insurance companies to federal resolution authority.<sup>3</sup> On October 17, 2011, FIO published a Notice in the Federal Register<sup>4</sup> asking for input on the statutory factors, and on December 9, 2011, FIO held a conference to solicit views from interested parties.

The report is the best indication available of how FIO plans to use its statutory authorities, and offers a window into the issues that are most on the minds of the FIO and the Treasury. Specifically, FIO makes nine recommendations for direct federal involvement in insurance regulation, all of which it currently has the authority to undertake. FIO also makes eighteen recommendations for near-term reform for the states, and reminds Congress of how Congress has intervened in the past when the states have been unable or unwilling to confront insurance regulatory challenges, as it did with NARAB. However, consistent with the charge from Congress, the report does not analyze the biggest change already wrought by Dodd-Frank: the supervision of designated systemically important financial institutions (“SIFIs”), including some insurers, by the Board of Governors of the Federal Reserve System (“Federal Reserve”).

#### *Federal Action Recommendations*

FIO currently has the authority to act immediately on each of the nine recommendations in the report. Some of the recommendations for federal action are narrowly focused (*e.g.*, the accessibility and affordability of insurance on Native American lands; personal auto insurance policies for U.S. military personnel) and some are larger projects with national and international implications (*e.g.*, engaging in supervisory colleges to monitor financial stability and identify gaps in the regulation of large national and internationally active insurers; pursuit of a “covered agreement” among international regulators regarding reinsurance collateral requirements). Many of the recommendations call for FIO to monitor and gather data on the industry, and many explicitly call for coordination with state regulators. The complete list of areas for direct federal involvement is contained in the annex to this memorandum.

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<sup>3</sup> The other additional factors are: the feasibility of regulating only certain lines of insurance at the federal level; the ability of any potential federal regulator to reduce regulatory arbitrage; the ability of a federal regulator to provide robust consumer protection; and such other factors as the FIO Director determines necessary or appropriate.

<sup>4</sup> Public Input on the Report to Congress on How To Modernize and Improve the System of Insurance Regulation in the United States, 76 Fed. Reg. 64174 (Oct. 17, 2011).

To date, the FIO's international work has been conducted through the authority granted under the Dodd-Frank Act "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters";<sup>5</sup> the initiative regarding reinsurance collateral requirements would be FIO's first use of its "covered agreement" authority.<sup>6</sup> This authority allows FIO to enter into covered agreements with one or more foreign regulators resulting in binding regulation and preemption of any conflicting state laws, regulations or practices. The FIO proposes to use this authority for reinsurance collateral requirements in order to remedy "the complicating effect of state-by-state inconsistency on economic matters of national interest" even while recognizing that state regulators have recently undertaken constructive efforts in this area.

#### *Areas of Near-Term Reform for the States*

The report makes eighteen recommendations for near-term reform for the states. Some recommendations address areas of substantial current discord among the states, including the use of captives and the proposed implementation of principles-based reserving. Other recommendations demonstrate that FIO has a strong view on a number of current insurance regulatory issues, even if those issues may have no evident impact on international relations or systemic stability (*e.g.*, the use of marital status as an underwriting or rating consideration; regulatory oversight of vendors that provide insurance score products). The complete list of areas of near-term reform for the states is also included in the annex to this memo.

Notably, a number of the recommendations directed at the states involve areas with growing federal involvement and oversight due to the Federal Reserve's supervision of designated SIFIs, which are among the largest insurers in the country. These areas include: solvency oversight; capital adequacy; corporate governance; group supervision and regulatory congresses; and resolution of insolvent insurers and the state guaranty fund system.

#### *Conclusion*

The Dodd-Frank Act established a number of tools for increasing federal involvement in insurance regulation. The FIO report outlines current plans for the use of some of those tools, including direct action by FIO and indirect action via FIO's highlighting of issues for action at the state and NAIC level. However, the Administration chose not to use the FIO

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<sup>5</sup> 31 U.S.C. Section 313(c)(1)(E).

<sup>6</sup> 31 U.S.C. Section 313.

report to offer insights into the most prominent expansion of federal authority into the insurance sector, the Federal Reserve's supervision of insurer SIFIs.

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Please do not hesitate to contact us with any questions.

December 24, 2013

**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.

## 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 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.