BIPARTISAN POLICY CENTER

Improving U.S. Insurance Regulation

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ABOUT THE FINANCIAL REGULATORY REFORM INITIATIVE

This paper is a product of the Financial Regulatory Reform Initiative (FRRI) at the Bipartisan Policy Center. Since 2012, FRRI has been assessing the progress of post-financial crisis reform to determine what is and what is not working and making recommendations to improve the financial regulatory system.

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Executive Summary

The business of insurance is a foundational building block of the U.S. economy. As part of the country's financial history, the regulation of the business of insurance is grounded in a globally unique, state-based regulatory system, which has evolved over time. Generally, this system has served policyholders well, although there are areas such as the consistency and coordination of insurance regulation where improvements can and should be made from a policyholder's perspective. Increasingly over time, the business of insurance has evolved from primarily a local product offering to, in many cases, a national and international one, with companies adapting their business models to meet the dynamic needs of their customers regardless of where they reside or do business.

As a result, the regulation of insurance also has changed over time as well, with both increased intervention by the federal government and the emergence of global insurance standards for solvency, transparency, and risk management, among other things. This intervention at the national and international levels was accelerated by the recent global financial crisis, which resulted in new national laws and even tougher global standards. Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)—such as the ability to designate and regulate some large insurance companies as systemically important and the creation of the Federal Insurance Office (FIO) within the Treasury Department—are just two recent examples of the changing nature of the oversight of insurance.

The start of a new presidential administration and a new Congress provides an opportunity to reassess and rethink existing policies, laws, and regulations that impact a vital component of the U.S. economy. There has been too little analysis and policy discussion of insurance regulatory reforms at the state, national, and global levels from the perspective of their impact—individually and collectively—on both policyholders and the economy. This Bipartisan Policy Center paper attempts to fill that void by raising important policy issues regarding the regulation of insurance—a business that touches almost every aspect of U.S. economic activity.

BPC offers the following recommendations to improve the regulation of insurance at the state, national, and global levels to better serve the interests of policyholders and the economy. These recommendations address current issues in state-based regulation, achieving better outcomes for policyholders, existing federal oversight, potential future federal actions if states fail to act, and finally, international insurance regulatory standards.

Improving State-Based Insurance Regulation

1. **Provide Sufficient Resources and Authority**—State legislatures should provide state insurance departments with the resources they need to attract and retain quality personnel, and to perform the department's core functions at a high level. Further, state legislatures should provide state insurance departments with sufficient resources and authority to fully participate in supervisory colleges. Congress should request a report from FIO that assesses state legislative funding of departments and recommends the appropriate level of resources.

2. **Assess and Limit Use of Contingency Contractors**—The National Association of Insurance Commissioners (NAIC) should develop and include metrics on the use of third-party and any other off-budget contractors by state insurance departments in their annual insurance department resource reports. Congress should request an assessment from FIO on the use of contingency and other off-budget contractors.

   State insurance departments should hire long-term employees to do work they can reasonably expect will need to be performed regularly. The NAIC should work with states to establish national standards of expertise, transparency and accountability, and conduct for contractors.

3. **Reduce Variations in Solvency Regulation**—State solvency regulation should be more uniform to avoid disparities in standards and to prevent regulatory arbitrage. State regulators should develop a metric to measure state investment and accreditation standards against some baseline that ensures greater consistency, and subjects state compliance to independent audits.

4. **Improve the Transparency and Capacity of the State Guaranty System**—States should consider improvements to the transparency of their state guaranty systems to make consumers aware of the existence of, and changes in, coverage limits. States also should periodically assess how well guaranty funds would be equipped to handle stress scenarios, as well as the adequacy of the assessment base.

5. **Enhance the Transparency of Reinsurance Captives**—States should require full financial statements for all captive reinsurance entities. The NAIC should assess and publicize risks transferred to captives, the impact of such transfers on the capitalization of insurers, and the potential for maturity mismatches.

Improving Outcomes for Policyholders

1. **Replace Rate Regulation with Enhanced Consumer Protections**—States should end the practice of rate regulation and implement additional changes to their market conduct oversight practices that would be more effective in protecting consumers.

2. **Develop and Publicize Value Metrics**—Market conduct regulators should establish and publicize metrics to demonstrate the value of insurance policies to consumers, and make those metrics publicly available to assist consumers in shopping for policies. These metrics should take into account information such as an insurer's claims history, customer satisfaction surveys, policy loss ratios, and other factors that would help to demonstrate the expected value of a policy.

3. **Modernize State Data Collection**—States should actively build on ongoing data collection efforts to expand data availability to help consumers make better informed decisions and choices. States should develop and collect data on market outcomes and tailor that data for each state to identify any issues that require further analysis.

4. **Implement Customer Surveys**—State market conduct regulators should require insurers to conduct standardized satisfaction surveys of their customers so that regulators can make the aggregated results of the surveys for each company available to consumers where appropriate.

5. **Ensure Market Competitiveness**—In cases where a market for a line of insurance is not sufficiently competitive, regulators should assess whether they could encourage the development of an online market for that type of insurance.

6. **Ensure Risk-based Premiums**—Premiums for disaster insurance should reflect the actual risk being insured.

7. **Make Disclosures More Consumer-friendly**—State insurance regulators should establish simplified consumer disclosure forms to display, consistently and at-a-glance, the key relevant information on policies and value metrics for consumers.

8. **Prohibit Price Optimization**—State insurance regulators should prohibit the setting of premiums on any criteria other than sound actuarial principles. If any subsidies are to be provided, they should be made income-based and supported by direct payments.

9. **Grant a Cooling-off Period for Add-on and Credit Products**—Consumers should be allowed a "cooling off" period of three business days during which they may reverse their decision on whether or not to purchase a credit insurance or other add-on insurance product. The consumer's ability to cancel should be made clear and prominent at the point of sale.

Improving Existing Federal Oversight

1. **Better Rationalize FIO**—Congress should elevate FIO to a bureau within the Treasury Department or make it an independent agency outside of Treasury. FIO should be funded by assessments of U.S. insurers and led by a director with a six-year term who would be appointed by the president and confirmed by the Senate. Congress also should allow the FIO director to serve beyond their term in office until a successor is appointed and confirmed by the Senate. Congress should combine the roles of FIO director and FSOC independent member and make the holder of the new position a voting member of FSOC.

2. **Monitor State Regulation**—Congress should require an annual report from FIO on the activities and governance of the NAIC and state insurance regulation and hold hearings on each report.

3. **Make NAIC Policymaking More Transparent**—The NAIC should adopt Administrative Procedures Act (APA)-like standards and Government in the Sunshine-like standards to ensure greater transparency in policymaking.

4. **Develop a More Formal FSOC Process for Insurers**—Congress should require that FSOC seek a formal opinion from FIO in each case in which an insurer is considered for designation or de-designation as a systemically important financial institution (SIFI). FSOC should be required to assess a firm's vulnerability to material financial distress before it designates—or de-designates—an insurance SIFI.

5. **Improve State-Federal Coordination**—Congress should require FIO to establish an advisory committee of state regulators chosen by the NAIC. The director of FIO should meet regularly with this group and seek their counsel on any important matters within the purview of both FIO and state regulators.

6. **Streamline the Process for Appointing NARAB Board Members**—Members of the National Association of Registered Agents and Brokers (NARAB) board should be appointed by the president without requiring Senate confirmation.

7. **Promote a Well-Functioning Market for Cyber Insurance**—Policymakers should focus their resources and actions on how to overcome the obstacles to a fully functional market for cyber insurance.

8. **Pursue a State Compact**—States should consider pursuing a compact to provide for coordinated supervision of insurance groups.

Options for Future Federal Involvement

Together, the foregoing recommendations will enhance the capabilities of federal policymakers while retaining the primacy of the state insurance regulatory system. However, if material progress is not made on other needed improvements in state regulation within a reasonable period of time—perhaps during the next four years—then the administration and Congress should consider additional federal involvement.

The following recommendations are predicated on Congress deciding to intervene in insurance policymaking and regulation at the national level in the future. **To be clear, we are not calling for either of these approaches at this time. We would prefer that states continue to be the primary regulators of insurance.** However, if states do not allocate sufficient resources for supervision and are not able to align behind more unified standards, then an enhanced federal role may be necessary to protect policyholders and the solvency of insurers.

Optional Federal Charter

1. **Create an Independent Insurance Solvency Regulatory Agency**—A "new FIO" should be the chartering authority and primary solvency regulator for insurance companies that opt for a federal charter, including the operating companies of SIFI insurers. The new FIO should be funded by assessments of the companies it oversees.

2. **Regulate Insurance Holding Companies**—The Federal Reserve Board should oversee insurer holding companies that include insured depository institutions, consistent with current law. The new FIO should oversee insurance holding companies without insured depositories.

3. **Keep Market Conduct Oversight with the States**—Consumer protection and other market conduct oversight of insurers that opt for a federal charter should be left to state regulation, subject to the improvements we recommended earlier in this report.

4. **Prohibit Rate Regulation**—Insurance companies that opt for a federal charter should not be subject to rate regulation.

5. **Mandate a Federal Charter for SIFI Insurers**—Any SIFI insurer should be required to opt for a federal charter.

Setting Minimum Standards

1. **Set Minimum Federal Standards on Risky Activities**—If Congress prefers an approach of setting minimum federal standards, it should give FSOC the authority to direct FIO to set minimum federal standards to sufficiently address the risk posed by that activity. Another approach to minimum standards outside the context of systemic risk would be to trigger FIO's ability to set standards when the NAIC's membership votes to make a provision a part of its financial accreditation standards.

2. **Focus on Activities and Products**—Congress would be better served by focusing FSOC on an activities-and-products-based approach to systemic risk rather than on SIFI designation. Minimum federal standards is one way to achieve this end.

3. **Tailor Oversight**—The Federal Reserve should continue to pursue a policy toward insurers within its jurisdiction that is tailored to the business of insurance.

Responding to International Insurance Issues

1. **Continue to Prioritize Policyholder Protection**—The United States should resist any effort to shift to an approach that could allow insurance subsidiaries to be used as a "source of strength."

2. **Participate Fully in Global Forums**—U.S. regulators should fully engage with global insurance forums—and provide the resources necessary to do so—to the extent they are compatible with protecting U.S. policyholders.

3. **The U.S.-EU Covered Agreement**—The U.S.-EU covered agreement should help the United States make its case for equivalence under Solvency II, and there seems to be no compelling reason not to use the agreement to make changes to reinsurance collateral issues permanent. Assuming the Trump administration agrees, we expect that they will move forward with the covered agreement at the appropriate time in the process.

4. **Do Not Adopt Mark-to-Market Accounting Standards**—U.S. policymakers should continue to avoid the adoption of mark-to-market accounting rules for insurance assets in any way that could reasonably be expected to trigger or fuel fire-sale dynamics among insurers.

5. **Include FSOC's Independent Member in "Team USA"**—FSOC's independent member should be included on "Team USA" and consulted by its other members on all issues in which systemic risk overlaps with insurance.

6. **Study the Impact of G-SII Designations**—The Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) should study the impact of global systemically important insurer (G-SII) designations on domestic insurance markets and policyholders.

Introduction

The Role of Insurance in the United States

Insurance is part of the "financial plumbing" of the economy that is easily overlooked but important to consumers and businesses because it helps them reduce their exposure to risks. This is crucial to business formation and growth, and to providing financial certainty for individuals and their households by ensuring their financial viability if they are victimized by accidents or misfortunes they cannot control.

Consumers who purchase insurance (policyholders) reduce their own risk by shifting it to insurers, paying premiums to an insurance company in exchange for a promise by the insurer to pay for a future loss covered by the policy. Insurers count these policy obligations as liabilities on their balance sheets.

Paradoxically, insurers better manage their own risk by taking on *more* policyholders, so long as the risks of those policies are diversified and properly underwritten (in other words, the insurer accurately assesses its risk in issuing a policy and charges a premium commensurate with that risk). This win-win situation is made possible by the law of large numbers, which allows insurers to pool risks from their policyholders, spreading their liability for losses over a diverse group of consumers, on the assumption that these losses are largely independent of each other.

The insurance industry has grown along with the overall U.S. economy. It is now a major component of both the U.S. financial industry and the U.S. economy.

In 2015, for example, U.S. insurers issued policies that charged about $1.15 trillion in net premiums to policyholders.[1] Of that amount, life/health insurers—consisting mostly of life insurance policies and annuities contracts, and not health insurance, which we do not address in this report—accounted for about 55 percent of those premiums. Property/casualty insurance—consisting mostly of home, auto, and commercial insurance—accounted for the other 45 percent.[2]

U.S. insurers manage substantial portfolios of assets, which represent the sum of shareholder or policyholder "capital" and cumulative amounts of premiums collected over time, minus claims payouts and insurer expenses. At year-end 2015, life/health (hereafter "life") insurers collectively held about $6.3 trillion in assets; the corresponding figure for property/casualty (hereafter "P/C") insurers was about $1.8 trillion.[3] Insurers invest premium dollars in assets to earn income to pay policyholder claims and other business expenses, and also to match the timing of when assets mature to when insurers expect they will need to pay claims. For example, life insurers generally invest in longer-term assets such as long-term government and corporate bonds or real estate because it often takes decades from the time a person buys a life insurance policy until the insurer must pay out a claim on that policy.

The insurance industry's economic impact can be seen in its physical size as well. The Federal Insurance Office (FIO) reports that there were 995 life insurers and 2,673 P/C insurers licensed in the United States in 2015.[4] According to the Insurance Information Institute, the industry employed just over 2.5 million people that same year.[5]

Why and How Insurance Is Regulated

The insurance industry's economic importance is one reason for government oversight. Since the value of insurance to consumers is in knowing they will be paid for losses they incur, the primary goal of insurance regulation has been policyholder protection.

Policyholder protection involves ensuring that insurance companies are solvent: that they have enough assets set aside to pay expected claims, that their investments are not too risky, and that they are otherwise financially sound. Insurers are also subject to business conduct regulation, which can include oversight and regulation of such areas as governance, premium rates that insurers are allowed to charge, discriminatory and predatory sales practices, and the complexity and standardization of policies and forms.

The industry is also regulated because market discipline alone does not ensure that policyholders will be paid and consumers protected from deceptive, discriminatory, or predatory practices.

U.S. insurance regulation has long been handled almost exclusively by states.[a] This framework was written into federal law in 1945 with the passage of the McCarran-Ferguson Act,[6] which exempted the business of insurance from most federal regulation. McCarran-Ferguson was reaffirmed by Congress as recently as 1999 in the Gramm-Leach-Bliley Act.[7]

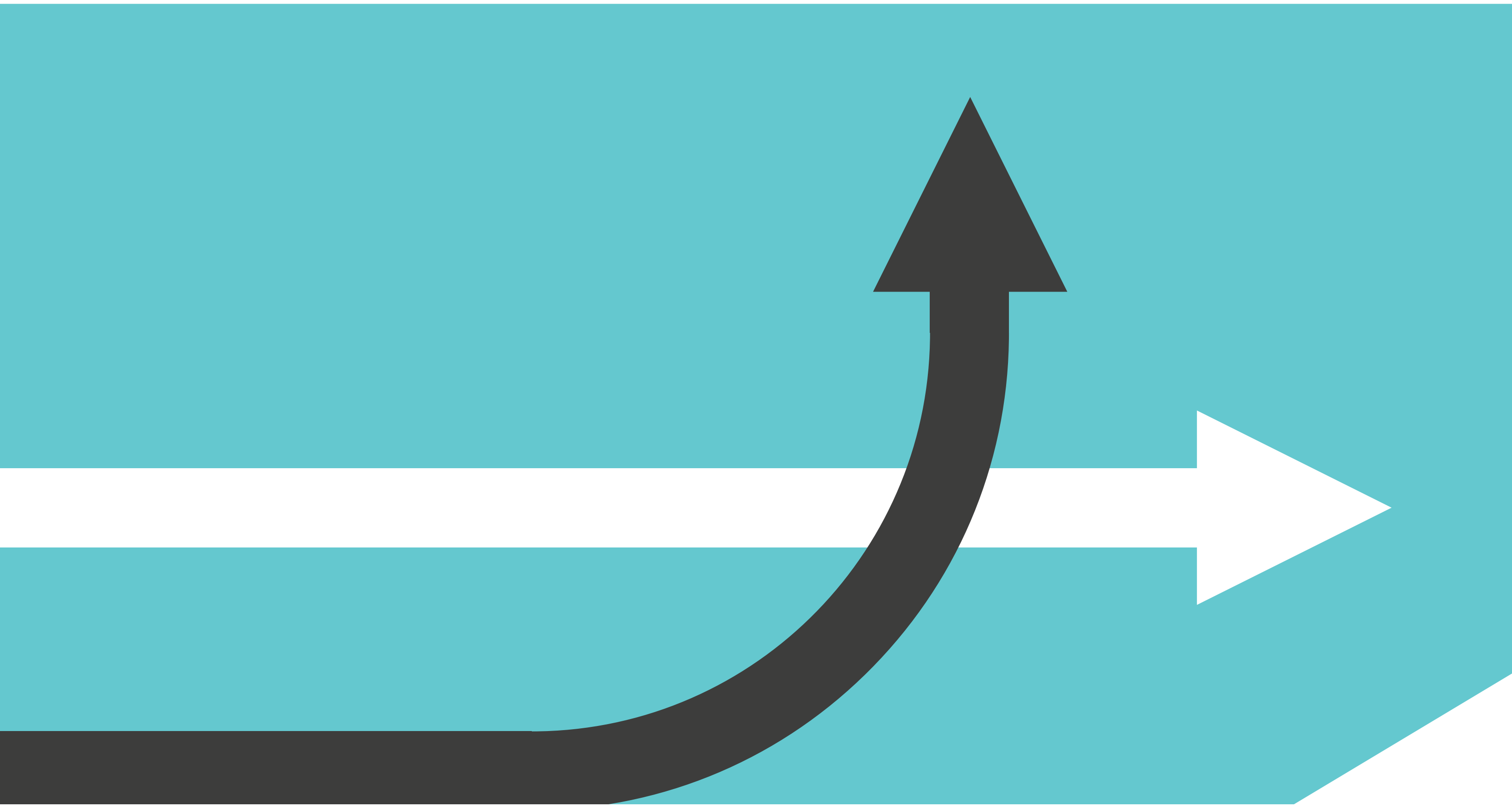
Under the current system, the state where an insurer is domiciled plays the primary role in regulating the firm's financial condition. Other states in which an insurer is

[a] There are a few exceptions to this, such as the National Flood Insurance Program and Terrorism Risk Insurance Program, which are federal programs instituted in part because they involved risks that private insurers were unable to properly price or otherwise to take on.

authorized to do business can also exert regulatory authority, but they generally defer to the insurer's home state as long as they have confidence in that state's regulators.
While states generally defer to the home state on matters, state regulators monitor the business operations of all insurers doing business in their states, perform both regular and targeted exams of insurers' market practices, and otherwise regulate business conduct.

State insurance commissioners also coordinate many of their efforts through the National Association of Insurance Commissioners (NAIC), created in 1871. Although the NAIC has no regulatory authority or ability to force state insurance departments to take specific actions, the NAIC has been active in coordinating state regulation through a variety of tools such as financial accreditation standards for state departments and model laws and guidance for how insurance should be regulated.

Insurance Regulation and Supervision Is Changing



Prior to the 2007-8 financial crisis, some policymakers and insurers, particularly those with operations in multiple states, advocated for a greater federal role in insurance regulation. Legislation was offered in both the Senate and the House to create an optional federal charter (OFC) that would give insurers the option to choose primary regulation by a federal agency instead of state regulators.

The near-failure of insurance giant American International Group, Inc. (AIG) in 2008 made the debate about federal involvement in insurance regulation a higher priority for Congress. AIG had a federal regulator, the Office of Thrift Supervision (OTS), which was much criticized for its failure to adequately supervise AIG and other large thrift institutions that destabilized the financial system in 2007-8. Before the crisis, the OTS had only one insurance expert on its staff, and the Treasury Department, which operated at the heart of the U.S. crisis response, also had little expertise on the subject.[8]

Congress decided against an OFC but authorized increased federal involvement in the business of insurance to an unprecedented degree to address the financial problems related to insurance. In the Dodd-Frank Act, Congress:

- Created the Financial Stability Oversight Council (FSOC) and gave that agency the authority to designate "systemically important" nonbanks—including insurance companies—for supervision by the Federal Reserve Board (Fed Board). FSOC initially designated three insurers as systemically important financial institutions. One such decision was overturned by a federal court in 2016,[9] although the U.S. government has appealed that ruling;[10] whether that legal course will be followed by the Trump administration remained to be seen as this report went to press. Congress also authorized FSOC—which includes a voting member with insurance expertise and a nonvoting member who is a state insurance commissioner—to make recommendations to state insurance regulators to address specific acts and practices of insurers.

- Created FIO within the Treasury Department, and gave that office the authority to monitor insurance markets, to represent the United States at meetings of the International Association of Insurance Supervisors (IAIS), and to enter into "covered agreements" with other countries in order to regulate certain insurance activities. FIO reached such a covered agreement with the EU in January.
- Created the Office of Financial Research (OFR) within the Treasury Department and gave that office the authority to require reports from insurers and to conduct research on insurance markets and practices. The OFR, like FIO, also advises FSOC on the designation of insurers as SIFIs.
- Gave the Fed Board supervisory and regulatory authority over insurer SIFIs as well as insurers that are affiliated with insured depository institutions. The Federal Reserve has said it will focus on group supervision of insurance holding companies and mitigating risks to financial stability in its oversight of insurers, rather than duplicating state-based regulation.[11] The agency has advanced a proposal to apply capital standards to insurance companies that the Fed Board oversees.[12] What further actions the Federal Reserve may take with respect to this proposal as new governors are appointed to the Fed Board by the Trump administration also remains to be seen.

Expanded Engagement of International Supervisory Bodies

Globalization and the financial crisis also triggered a reevaluation of insurance regulation by international financial supervisors. In 2009, the G-20 countries established the Financial Stability Board (FSB) to promote financial stability and to coordinate policy and information sharing among national financial regulators and international standard-setting bodies at a global level. The membership of the FSB consists of representatives from 23 countries, Hong Kong, and the European Union; four international financial institutions; and six international bodies.[13] The United States is represented by the Treasury Department, the Fed Board, and the Securities and Exchange Commission (SEC).

One of the international bodies that is a member of the FSB is the IAIS, which was created in 1994 to establish global standards on insurance supervision and coordinate the efforts of national insurance supervisors and other global financial regulators. The IAIS is a voluntary association that represents insurance regulators and supervisors from more than 200 jurisdictions and close to 140 countries. The United States is represented on the IAIS by the NAIC, FIO, and the Fed Board. The IAIS includes an executive committee that makes decisions necessary to achieve the objectives laid out by its membership.[14]

National regulators and supervisors are not legally bound by FSB or IAIS rules, which are advisory and must be implemented through regulation or legislation by authorities within each country. However, the actions of the FSB and the IAIS have influence since their work is negotiated by member countries. The FSB and the IAIS have undertaken initiatives to enhance regulatory standards and improve coordination among regulatory bodies. These include efforts to create a global framework for the oversight of Internationally Active Insurance Groups (IAIGs) and Global Systemically Important Insurers (G-SIIs), and to establish a global insurance capital standard.

More Potential for Regulatory Overlap and Conflict

As a result of the expanded federal supervision of insurers and increased engagement by international supervisory bodies, there is greater potential for overlap and conflict in insurance regulation that could result in inefficiencies and higher costs for policyholders and insurers.

Capital regulation is the most obvious example of this potential conflict. There are material differences in existing state risk-based capital (RBC) standards, the group capital standards under discussion in international forums, and the capital standards under development by the Fed Board for the insurers that it supervises.

Another potential consequence of this evolving system of insurance supervision is the creation of competitive disparities between insurers. Some insurers—particularly SIFIs—face "heightened" standards that will not apply to all insurers. Since the market for insurance is competitive, such a disparity could be disruptive to insurance markets and policyholders.

Principles for Sound Insurance Regulation

We have outlined above why it is important to regulate the business of insurance. However, regulations that are poorly designed, inconsistent, or overly complicated can impose unnecessary costs, harm competition, and inhibit innovation.

Overarching principles can establish important goals and policy direction to guide both rule-making and the execution of those rules.

In February 2017, President Trump issued an executive order that included a set of seven principles for how he intends to approach financial regulation.[15] Previous administrations have also laid out financial regulatory principles, including the Obama administration in the Treasury Department's 2009 *New Foundation* report[16] and the George W. Bush administration in the Treasury Department's 2008 *Blueprint* report.[17] Similarly, Chairman Jeb Hensarling (R-TX) included a set of principles in the Financial CHOICE Act legislation (H.R. 5983) he introduced in the 114th Congress in 2016.[18]

To avoid bad regulatory outcomes and unintended consequences, some foreign financial regulators have adopted principles to guide their regulatory policy. For example, the United Kingdom's Financial Conduct Authority is required to adhere to a set of principles in its regulation of retail financial products and services,[19] the Organization for Economic Co-operation and Development (OECD) has adopted a set of principles for guiding regulatory quality and performance,[20] and the New Zealand Treasury has published a set of regulatory principles.[21]

In developing the recommendations in this paper, we thought it important to have a set of principles in mind to guide our work. We relied on the following six principles for insurance regulation:

1. The primary objective of insurance supervision and regulation should be policyholder protection—ensuring that policyholders are paid when they incur a claim, and that they are not the target of unfair and deceptive activities and practices;
2. Consumers should have access to sufficient information to make informed decisions when shopping for insurance;
3. Insurance policies should be priced to reflect the actual risk that is being insured, in order to maintain well-functioning insurance markets;
4. Supervisory standards should be tailored to the business of insurance and avoid misapplying bank-like supervisory standards to insurers;
5. Supervision should be transparent, encourage innovation, and avoid distorting markets; and
6. Insurance regulatory agencies should have sufficient resources and authority to conduct effective supervision and to attract and retain qualified personnel.

Improving State Insurance Regulation

State regulators have long prioritized ensuring that policyholders are paid when they incur a claim. This involves protecting the solvency of insurers domiciled in their states and also policing market conduct of all insurers operating in their states. There have been failures in the state insurance regulatory system but, in general, state supervision of insurance has worked well for policyholders and insurers over many decades.

However, in the course of our interviews for developing the recommendations in this report,[b] a number of issues about state insurance oversight were raised as policy considerations for improvement. Several of these are discussed below.

State Budget Cuts Threaten the Effectiveness of State Regulation

For state insurance departments to be effective, they must have sufficient resources to perform their core functions of protecting policyholders by ensuring the solvency of domestic insurance companies and overseeing market conduct. State insurance departments collect significant revenues from premium taxes and regulatory fees charged to insurance companies and insurance agents and brokers, but most of these funds have been channeled to state programs rather than to insurance regulation.

[b] More information about BPC's interview questions and process can be found in Appendix A.

The Consumer Federation of America (CFA) recommends that state insurance departments keep at least 10 percent of the revenues they raise to fund their operations.[22] However, the average state budget in 2015 was only about 6 percent of revenues, down from 8.5 percent in 2000. In 2014, several state budgets were near or below 3 percent of revenues.[23]

The use of third-party contractors by state insurance departments is a related source of concern. In some states, examinations of insurers that have traditionally been done by state supervisors are being increasingly outsourced to contractors as departmental budgets have been cut.[24]

State insurance laws have long authorized departments of insurance to contract with third parties in certain situations. From time to time, departments might encounter a technical issue in an insurer that the department does not have the in-house expertise to analyze. However, these provisions were never designed to enable departments to cut back on expenses associated with core regulatory competencies.

For example, departments are required to periodically examine the financial condition of their domestic insurance companies. This workflow is predictable and easily managed in all but the most extraordinary of situations. Lately, both market conduct and financial examinations are increasingly being farmed out, while department staffing is stagnant or shrinking. This practice indicates that too many states are unwilling to adequately fund their departments, preferring to spend premium taxes and fees in other areas.

There are several perverse incentives at work here. State legislatures can make it look like they are cutting spending because the contractors are paid directly by the insurance companies being examined, meaning that their fees do not show up in state budgets. In addition, contractors who are paid on a per diem or hourly rate have an incentive to spend more time conducting exams. And since these contractors are not paid by states, insurance departments have less incentive to ensure that contractors are performing their work efficiently.

This is an example of what University of Pennsylvania political scientist John J. DiIulio, Jr. calls "Leviathan by Proxy," where actions are taken that make the government look smaller but, in reality, do not save money, make government more complex and inefficient, and "cannot predictably, reliably, or cost-effectively do what democratically enacted public laws dictate that it must."[25]

It is also problematic that we were unable to find aggregated data on the extent to which state regulatory departments are currently using contingency contractors. Such data would be a useful counterweight to current incentives to use contractors.

If states want to retain their insurance regulatory primacy and avoid greater federal involvement, they must ensure that their insurance departments are provided the necessary resources to do their work at a consistently high level of quality. This is the position of the NAIC, which requires sufficient qualified staff and resources, and the ability to attract and retain qualified personnel, for state insurance departments to maintain their NAIC accreditation.[26]

Recommendations to Address State Resource Issues

Provide Sufficient Resources and Authority

As a general rule, **all state legislatures should provide state insurance departments with the resources they need to attract and retain quality personnel, and to perform the department's core functions at a high level.**

Further, **state legislatures should provide state insurance departments with sufficient resources and authority to fully participate in supervisory colleges**, which are joint meetings of regulators and insurer officials that help to oversee IAIGs.[27] This includes not only adequate funding, but also the ability for key state supervisory personnel to travel to attend meetings of supervisory colleges.

To help achieve these goals, **Congress should request a report from FIO that assesses state legislative funding of departments and recommends appropriate levels of resources. FIO should then provide Congress with supplemental reports "scoring" the states on the extent of their achievement of these goals.**

Assess and Limit Use of Contingency Contractors

The NAIC should develop and include metrics on the use of third-party and other off-budget contractors by state insurance departments in their annual insurance department resource reports. At the same time, **the NAIC should amend its financial accreditation standards to limit this practice.**

Congress should request an assessment from FIO of the use of contingency and other off-budget contractors that includes, among other things: the extent to which they are used and their qualifications; the impact of such contractors on the ability of state insurance departments to attract and retain full-time staff to do similar work; whether such contractors make regulation more or less costly and effective; and the impact of budget cuts over time on the operations of state insurance departments, including the use of such contractors.

State insurance departments should hire long-term employees to do work they can reasonably expect will need to be performed regularly. The use of contractors should be reserved for performing non-core functions or work that occurs on an irregular and unpredictable basis, or requires technical expertise that it is not practical for a department to permanently employ.

To the extent that contractors are used, **the NAIC should work with states to establish national standards of expertise, transparency and accountability, and conduct for contractors and their employer companies that perform work for state insurance departments.**

Additional Issues in State Regulation

The Lack of Uniformity in State Regulation Is Inefficient

The NAIC has long served as a forum for the states to coordinate policy and has emphasized uniformity during much of its history.[28] However, the NAIC is not a regulator; it does not have the power to bind the regulatory actions of the states, and it cannot enforce consistent regulatory standards. Therefore, while the NAIC has done much over the years to establish uniform standards, variations in state oversight persist. For example, the NAIC established the Interstate Insurance Product Regulation Commission to facilitate the approval of new products in multiple states, but several key states—including New York, California, and Florida—do not participate in that program.[29] Some variations among states are appropriate based upon different market conditions, but variations also can create confusion and result in different levels of protection for policyholders.

The NAIC has developed an accreditation program that is intended to minimize variations in financial supervision among states. That program requires states to meet standards related to staffing, budgets, and examinations policies. Even under that program, variations in state supervisory policies have developed, largely due to exceptions to the standards adopted by individual states. Currently, state regulators and the NAIC determine compliance with the accreditation program.[30] A committee of state insurance regulators votes on whether to approve accreditation for other states, but it can be difficult to vote against one's peers.

FIO has highlighted a report from the McKinsey & Company consulting firm, which concludes that "per dollar of premiums, the costs of the state-based insurance regulatory system are approximately 6.8 times greater for an insurer operating in the United States than for an insurer operating in the United Kingdom, and increase costs for P/C insurers by $7.2 billion annually and for life insurers by $5.7 billion annually." This is not inconsistent with our call for states to provide greater resources to state insurance departments, as the inefficiency is due in large part to insurers operating in multiple states having to deal with different regulations and requirements in each state. And as FIO also points out, this inefficiency does not necessarily mean that federal regulation of insurance should replace state regulation but, rather, that improvements can be made to state regulation.[31]

State Guaranty Fund Coverage Varies and Has Not Been Severely Tested

Each U.S. state has set up non-profit guaranty funds to protect policyholders. Insurers are required to be members of these associations as a condition for their licensing. In the event of the failure of one or more insurers, a court may appoint the state insurance commissioner to liquidate the company to ensure that policyholders are paid. To the extent that liquidation will not cover all the claims made on the failed insurer, a guaranty fund can step in to pay additional claims. Most guaranty funds are funded after an insolvency occurs, by assessments on solvent insurers, generally up to 2 percent of net written premiums.

However, guaranty funds are not necessarily required to make policyholders whole. Coverage limits vary by state and sometimes vary substantially. For example, "a life insurance policyholder residing in the state of Washington may be eligible for up to $500,000 in guaranty fund protection for the policy's cash value, while a policyholder with the same product from the same insurer residing in Oregon is limited to only $100,000." Moreover, because insurers are not allowed to advertise the protections offered by guaranty funds in all but two states, consumers are generally unaware of these differences, or even that such coverage exists.[32]

In addition, although state guaranty funds have performed well since they were put into place starting in the late 1980s, they have not been tested by the failure of a major insurer or a large-scale disaster that may require exceeding the assessment base in multiple states.

Regulatory Arbitrage Is a Risk

The state system, with its 56 NAIC member states and jurisdictions, allows for regulators to tailor their oversight to the consumers and conditions that prevail in their own states. It can also be an invitation for states to lower their regulatory standards in an effort to lure more companies to their states, which can undermine policyholder protection. The NAIC's accreditation process and group-wide supervision of insurance groups are among the measures used to prevent regulatory arbitrage.

Greater Transparency Is Needed with Reinsurance Captives

A reinsurance captive is a special-purpose entity set up by an insurer to transfer risk within an insurance group from one insurer to another. Reinsurance allows an insurer to move some risk off of its balance sheet and thereby receive credit against its capital and reserve requirements. FIO has found, however, that "reinsurance captives are not subject to the same solvency oversight as a traditional commercial insurer or reinsurer." FIO also reported that "there is a lack of transparency for captive oversight from state-to-state."[33]

The OFR reported that, in 2014, about 45 percent of the $62 billion in transactions with captive reinsurers was exempt from the NAIC's new reporting requirements, and only about 35 percent of all captive transactions, as measured by reserve credit, were required to disclose asset information during the same period. The same report indicated that much of the information that is required to be filed is vague, is not useful in determining potential maturity mismatches, and does not quantify the effects of captive transactions on an insurer's risk-based capital ratio. The NAIC limited exemptions for required 2015 annual filings, but they were unavailable to be analyzed at the time of the OFR's report.[34]

Additional Recommendations to Improve State Regulation

Reduce Variations in Solvency Regulation

State solvency regulation should be more uniform to avoid disparities in standards and to prevent regulatory arbitrage. **State regulators should develop a metric to measure state investment and accreditation standards against some baseline that ensures greater consistency, and also subject state compliance to independent audits.**

Improve the Transparency and Capacity of the State Guaranty System

We do not believe it is necessary for each state to have the same limits on coverage from state guaranty funds. Different states have different conditions for consumers—such as cost-of-living and average incomes—making some variation in coverage limits acceptable. However, consumers should be aware of these differences.

Minnesota prohibits insurers from advertising the protections offered by the state's guaranty fund as a sales tool, but allows insurers to verbally explain those protections during the applications process or anytime afterward.[35] **States should consider this or a similar approach, and also consider making it mandatory to inform consumers who move to another state about changes in the coverage limit that would apply to them.**

In addition, states should periodically assess how well guaranty funds would be equipped to handle stress scenarios with significantly greater losses than these funds have faced to date. States should analyze the adequacy of the assessment base, how state legislatures would address losses that exceed the capacity of the assessment base, and whether criteria and assumptions need to be updated based on evidence or changes in the insurance or insurance regulatory marketplace.

Enhance the Transparency of Reinsurance Captives

To better ensure that regulators and market participants fully understand the financial condition of insurers, **states should require full financial statements for all captive reinsurance entities. The NAIC should collect and disclose this information about the financial condition of reinsurance captives, and also an assessment of risks transferred to captives, the impact of such transfers on the capitalization of insurers, and the potential for maturity mismatches.**

Market Conduct Regulation and Consumer Protection

As part of their mission to protect policyholders, states examine how insurers doing business in their states interact with policyholders. These market conduct examinations can include assessments of matters such as consumer complaints, misleading sales practices, and how quickly claims are paid. They can also include assessments to ensure that markets are competitive and otherwise well-functioning. Such examinations can be a valuable service to policyholders, but both consumer and industry groups have pushed for improvements.

Consumer groups have argued that instead of proactively monitoring markets to identify problems early—which consumer groups favor—states take an audit-like approach to exams that reacts to complaints and potential violations brought to their attention by consumers, journalists, and others. In 2009 testimony before Congress, the CFA noted that: "some states at some times have done well for consumers, but states as a group routinely fail to identify market problems or proactively protect consumers."[36]

Insurers find that state regulators often fail to coordinate examinations and, as a result, companies are subject to multiple and overlapping examinations. In its 2013 report on modernizing U.S. insurance regulation, FIO cited a 2011 survey by the American Council of Life Insurers (ACLI) in which 63 percent of the respondents rated current market conduct regulation as "unsatisfactory/needs improvement," and 78 percent cited a lack of uniformity as the major cause of dissatisfaction, along with "speed/timing," "cost," and "expertise/capacity."[37]

However, states have done well in a number of areas. CFA's 2009 testimony contended that there are several benefits: states are better-positioned to deal directly with consumers, there has been less price gouging in state-regulated insurance than in federally-regulated lending, state consumer websites generally provide good information, and states are responsive to consumer needs.[38]

On balance, we believe that states have performed well for consumers, but there are several issues that should be addressed. These are stated below, followed by recommendations to improve regulations that all states should consider adopting in the near future.

Consumers Have Imperfect Knowledge of What They Are Buying

Insurers have long struggled to demonstrate the value of their products to consumers. Most people know that it is wise to buy insurance, but it is human nature to feel as though money spent on insurance premiums is wasted if one does not collect on a claim. This is why consumers are more apt to purchase flood insurance immediately after a flood (or any natural catastrophe, including fires and windstorms) and drop their insurance as the disaster fades from memory.

The internet has enabled the development of websites that greatly improve the ability of consumers to compare prices or rates of similar or identical insurance policies, but consumers still do not always have useful, ready access to information about the companies that sell policies: their claims payment history, consumer satisfaction ratings, and more.

In addition, as we mentioned earlier, coverage by state guaranty funds can be confusing to policyholders.

Rate Regulation Distorts Markets

Rate regulation is a practice used in some form by most states to control the rates that can be charged for certain insurance policies, principally P/C products for consumers. Rates are regulated by states for a number of reasons, including: to protect consumers from having to pay unfair prices for policies, some of which they are required to buy; to ensure the solvency of insurance companies; and to promote actuarial pricing.

Even though this conclusion may seem counter-intuitive, rate regulation can harm consumers as well. Sometimes, rates are suppressed for political rather than economic reasons, which distorts markets. If rates are held at levels below where they are actuarially sound, or which would be obtained in a freely competitive environment, then rate regulation discourages insurers from entering those markets and encourages insurers in those markets to leave. The National Flood Insurance Program, where flood insurance rates are kept artificially low due to political pressure, resulting in government subsidization of people living in flood-prone areas, is a good example of how rate regulations can prove counter-productive.

Some Credit Insurance and Add-On Products Lack Competitive Markets or Transparency

The purchase of certain kinds of low-value insurance products has long been the subject of consternation for consumer advocates. These optional "add-ons" include such products as extended warranties on automobiles and travel protection on airline tickets. These also include credit insurance products, which protect policyholders against the inability to make payments on a loan. For example, a consumer could buy insurance to make payments on a mortgage in the event of death or disability.

Such add-ons are generally offered at the point-of-purchase for the underlying product rather than sold in a competitive marketplace after advance consideration by the consumer. So, for example, consumers may do extensive research on the kind of car they plan to buy, and auto insurance is a standardized product that most vehicle owners are required to purchase and for which comparison shopping is simple. However, most consumers do not consider whether to buy an extended warranty ahead of time.

Law professors Tom Baker and Peter Siegelman found that "sellers are able to charge prices for add-on insurance products that consistently and greatly exceed the cost of providing the insurance, well beyond what is possible in other parts of the consumer insurance market."[39]

We do not claim here that all add-ons and credit insurance have the same characteristics or that they should not be purchased. Some products are valuable to certain kinds of consumers, and consumers should make their own choices about how much risk they are willing to take on. They should also, however, have all the information available to them to make the best-informed decisions for themselves. In addition, consumers should be able to shop for such products in the same competitive environment that prevails in most lines of insurance.

Some Consumers Face Discriminatory Pricing

The business of insurance is built around risk; so is the way insurance is priced, by setting premiums. Insurers are compelled by competitive and regulatory requirements to take policyholder claim risks into account in setting rates.

Take competition. In a competitive market, which should be the setting for many of the P/C and life insurance lines that are the subjects of this report, the annual premiums established for an insured are not based on the value of the claims statistically likely to be made. In other words, the estimated premiums are not "actuarially sound." When that is the case, a competing insurer is likely to step into the breach and offer a premium roughly equal to the "expected value" of the claims risk posed by the consumer.[c] This is true whether the consumer presents a low or high risk; net present premiums will reflect the claims risk estimated by the insurer.

In practice, there is no way statistically that insurers can accurately put each person into their own risk category. Insurers operate by the "law of large numbers" and risk pools or categories that are too small or narrowly defined to permit statistically meaningful projections of loss claims will not work. Instead, insurers tend to use broad predictors of a consumer's claims risk: for auto insurance, these might include the vehicle's value, the owner's age, previous accident history, and/or traffic violations.

The law and regulatory policy also prevents insurers from basing their risk categories on certain prohibited factors, such as race, ethnicity, or religion (although some insurers have been criticized for using various proxies for one of more these factors they find to be useful statistical predictors of future claims costs, such as ZIP code, which may be a lawful risk factor but can sometimes be correlated with prohibited factors).

In short, competitive forces exert pressure on insurers to base the premiums they charge on actuarial risks. Disturbingly, during the course of our study, we heard from several sources that certain insurers in some states are departing from actuarial pricing, and using instead, or as a supplemental means of pricing, customers' "willingness to pay" in setting premiums ("price optimization"). More specifically, customers

[c] Technically, insurers add their overhead to the expected value of your claims risk, minus an adjustment for the insurer's earnings per policyholder on the investments of its earned premiums.

who show less sensitivity to variations in premiums—and are thus less willing to shop around—are charged more than other customers who have characteristics suggesting that they are more price-sensitive. To the extent these practices occur and are not cured by market forces or not prohibited by sound regulation, they violate a fundamental principle of fair insurance pricing.

Recommendations to Improve Consumer Outcomes

Replace Rate Regulation with Enhanced Consumer Protections

Price regulation usually comes about in response to monopoly-like practices or to market failures that call for additional consumer protection. Yet, personal lines P/C and life insurance markets generally are competitive, especially since access to the internet has become widely available. Most policies also are relatively straightforward and simple to understand. Further, artificially low rates can threaten the solvency of insurers that provide policies at those rates, and therefore threaten policyholder protection. Some observers have said that, in states having a reputation for failing to approve rate increases, insurers may be reluctant to reduce rates when appropriate out of concern they won't be able to increase them when conditions change. For all these reasons, it makes little economic sense for regulators to set P/C insurance rates.

There are non-economic justifications for regulating rates, but we do not find them persuasive since we believe that similar goals can be achieved by other, less market-distorting means that we will lay out later in this section. The experience of the EU, which deregulated rate setting in 1992, is instructive. Following deregulation, the EU saw increased competition and lower premium rates, and fewer insolvencies.[40]

We recommend that states end the practice of rate regulation, and implement additional changes to their market conduct oversight practices that would be more effective in protecting consumers. To the extent that individual states continue to regulate rates, they should be set to reflect the actual risks being insured, and insurers should be prohibited from using "willingness to pay," "price optimization," or non-actuarial bases for setting rates (we address this subject again below).

Develop and Publicize Value Metrics

Market conduct regulators should establish and publicize metrics to demonstrate the value—benefits relative to costs—of insurance policies to consumers, and make those metrics publicly available to assist consumers in shopping for policies. These metrics should take into account information such as an insurer's claims history, customer satisfaction surveys, policy loss ratios, and other factors that would help to demonstrate the expected value of a policy.

The United Kingdom's Financial Conduct Authority (FCA) has developed an initiative that could serve as a template for state regulators. The FCA has been assessing value metrics that might be useful for consumers, and it started a pilot program in early 2017 to test them. The pilot program will measure claims history, claims acceptance rates, and average claims payouts.[41]

Assessing the costs and benefits of policies involves making subjective judgments, and individuals have their own risk tolerances and circumstances. Nevertheless, such metrics could be useful for consumers both in shopping for insurance products and in understanding the value of having insurance coverage.

Also instructive in thinking through how to better explain the value of insurance is the work of Wharton School professor Howard Kunreuther, who has proposed a number of ways that behavioral economics could be used to overcome biases that people exhibit when making decisions about purchasing disaster insurance. These behavioral biases include the tendency to focus on recent experience as a guide to estimating the likelihood and significance of future disasters, failing to take preventive measures prior to a disaster, and focusing on short time horizons.[42]

Kunreuther proposes that these problems can be addressed in part by providing better information on the role of insurance, focusing on the consequences of being uninsured, and presenting the likelihood of events as closer to a shorter time horizon. He also suggests offering multi-year policies as a way to encourage investment in preventive measures.[43] **Both state regulators and insurance companies should consider implementing these suggestions in their dealings with consumers.**

Finally, in line with the third of our principles for sound insurance regulation, we agree with Kunreuther that **premiums for disaster insurance should reflect the actual risk being insured.**

Modernize State Data Collection

Many of the above recommendations depend on the availability of the right data to regulators. The increased use of so-called "Big Data" by the NAIC has helped in this regard. It allows state commissioners to see national trends and be more proactive in addressing potential issues. And, centralizing data aggregation and analysis has efficiency benefits. Consumers also can benefit from insurers having access to more data by allowing firms to better tailor policies to individual customers.

However, insurers are using Big Data, too, including from a number of sources over which state insurance departments do not have oversight. It is becoming more difficult for regulators to know how insurers are making pricing, marketing, and other decisions. This can be a problem for consumers when, for example, it leads to price optimization or is used as a proxy for discrimination against protected groups. **States should actively build on ongoing data collection efforts.** Each state's insurance market has different characteristics and dynamics, and different political objectives and ways to protect policyholders. **States should work with the NAIC to develop and collect data on market outcomes and tailor that data for each state to identify any issues that require further analysis.**

Expanding the available data will help state market conduct regulators be more proactive and better serve consumers. In addition, the new data would help state insurance departments develop value metrics for insurance.

Implement Customer Surveys

State market conduct regulators should require insurers to conduct standardized satisfaction surveys of their customers so that regulators can make the aggregated results of the surveys for each company available to consumers where appropriate. This will provide further incentives for insurers to provide high-quality service.

Ensure Market Competitiveness

Our contention that states should end rate regulation is based on the view that it is not necessary in competitive insurance markets, and that rate regulation reduces competition by providing incentives for insurers to leave or not enter a market. **We believe markets are competitive for most lines of insurance, but market conduct regulators should take steps to ensure this is so.**

The Herfindahl-Hirschman Index is a useful metric of market concentration and competitiveness. A line of business with a consistently low loss ratio—in other words, one that pays out claims well below premiums collected—may be a sign of a market that is not sufficiently competitive. Regulators may also choose to make use of market competitiveness surveys where appropriate. **In cases where a market for a line of insurance is not sufficiently competitive, regulators should assess whether they could encourage the development of an online market for that type of insurance.**

Make Disclosures More Consumer-Friendly

Working through the NAIC, state insurance regulators should establish simplified disclosure forms to display, consistently and at-a-glance, the key relevant information on policies and value metrics to consumers. Disclosures should be rated at a **minimum Flesch-Kincaid readability score of 80**, which is consistent with a sixth grade reading level. Separately, consumers should be able to readily access information on the financial condition of insurers operating in their respective states.

Prohibit Price Optimization

In the economics literature, charging more to consumers who are less price-sensitive has been called price optimization or "Ramsey pricing," a method named after the late British economist Frank Ramsey, who showed that such pricing can both be most profitable for the firm engaging in it and also economically efficient, provided customers are fully and equally informed about the nature and quality of the good or service being priced. Examples of price optimization can include "peak-load" pricing of electricity or "surge pricing" for using Uber or Lyft at busy times of day: such prices are highest when energy use and/or travel is most demanded. In those circumstances, it is appropriate to charge the least price sensitive customers—those willing to pay for energy or travel at such peak times—higher prices than at other times of the day.

We and insurance regulators and regulatory experts with whom we spoke do not endorse price optimization for insurance. In particular, poorer and/or less educated or sophisticated customers may not be sensitive to variations in insurance pricing due to lack of knowledge, or not having the time or ability to seek multiple insurance quotes or easy access to the internet, where different websites have made insurance pricing much more transparent. These realities violate an important condition for the effective implementation of price optimization. **We therefore recommend that state insurance regulators prohibit the setting of premiums on any criteria other than sound actuarial principles. If any subsidies are to be provided, they should be made income-based, and supported by direct payments, rather than achieved artificially, counter-productively, and unfairly by suppressing rates for all insureds.**

Grant a Cooling-Off Period for Add-On and Credit Products

The additional disclosures we outlined earlier can help to better inform consumers about credit and add-on insurance products. In addition, when it is appropriate to the product and the right to cancellation of a policy is not already in place, **consumers should be allowed a "cooling off" period of three business days during which they may reverse their decision on whether or not to purchase a credit insurance or other add-on insurance product. In addition, the consumer's ability to cancel should be made clear and prominent at the point of sale.**

There are precedents in the United States and internationally for such periods. The Federal Trade Commission, for example, allows a three-day window for consumers to cancel transactions that take place at a location that is not the seller's permanent place of business.[44] United Kingdom consumers may cancel, without penalty or giving any reason, certain insurance contracts within a period of between 14 and 30 days of signing a contract.[45] A cooling-off period for credit insurance and add-on insurance products will give U.S. consumers a chance to conduct due diligence and shop for competitive offers.

The Appropriate Federal Role in Insurance Regulation

As mentioned earlier, part of Congress' reaction to the financial crisis was to improve the level of the federal government's knowledge about the business of insurance, and give federal agencies the ability to engage in insurance policymaking in certain cases.

During the course of our process for developing this report, we heard a number of concerns about federal insurance regulation, including that:

- Insurance oversight would not be given a high enough profile within the Federal Reserve, which has a long history of monetary policy and bank regulation, but little history with insurance. This leads some to fear that the Fed Board will make concessions to foreign regulators on insurance matters to gain concessions on banking matters that the agency might consider more important;
- Federal regulators, due to their experience with and expertise in banking, could use bank-like rules to regulate insurance even though the businesses of insurance and banking have important differences; and
- The new federal role is taking us down a road to a federal insurance regulator and charter, which would undermine the state-based system that has worked well for decades.

Since the passage of Dodd-Frank, the Fed Board, FIO, FSOC, and the OFR have all gradually hired staff with specific experience in the business of insurance. While their manpower and expertise cannot match the thousands of people employed by state insurance departments and the NAIC, these three federal entities have engaged in the policy process both within the United States and in global forums.

For example, the Fed Board has begun its public policymaking process of setting capital standards for the insurance companies it supervises. To date, the agency's approach generally has been seen as cautious and nuanced. Fed Board Governor Daniel Tarullo, who left the Fed Board in April and who led that agency's regulatory and supervisory efforts from 2009-2017, made it a point to say that the Fed Board would reject the global approach to insurance capital standards to the extent it was not a match for the U.S. insurance system.[46]

Nonetheless, the federal role in insurance regulation is still relatively new and untested. In the following sections, we examine a few of the issues related to federal supervision of insurance.

The NAIC Is a Quasi-Regulator Not Subject to Typical Oversight or Accountability

In recent years, as state insurance department budgets and staffing have not kept pace with changes in the industry and the use of Big Data has become more common, the NAIC has increasingly stepped in to provide services to states, some of which states used to handle themselves. For example, the NAIC offers states information technology support and aggregates data in a number of areas, including insurer financial statements.

To an extent, this is a welcome development. Data aggregation can spot trends and problems across states in a way that individual states would find difficult to uncover themselves. The NAIC is better able to employ people with certain specialized skills who can work on similar issues for multiple states, as opposed to each state hiring its own specialists. And if states are not providing sufficient resources to their insurance departments, the NAIC can step in to fill a gap, and has done so.

This trend becomes problematic, however, if and when states effectively defer core supervisory or regulatory tasks to the NAIC. To the extent that happens, the NAIC becomes more like a national regulator, but one without the full regulatory authority to enforce laws and rules, and conduct oversight that other such organizations have in the absence of a binding state compact.

Unlike federal regulatory agencies, the NAIC is a private not-for-profit organization, and is not subject to procedures designed to ensure transparency, such as the Administrative Procedures Act (APA), the Federal Advisory Committee Act, the Freedom of Information Act, the Government in the Sunshine Act, and the Paperwork Reduction Act of 1980. In addition, most of the NAIC's operating revenue is generated from fees imposed on insurers and producers for the use of various databases and other services.

Rep. Ed Royce (R-CA), who has advocated for a federal insurance regulator, has called the NAIC a "de facto regulator" that imposes its will on insurers through the accreditation process. Former Florida Insurance Commissioner Kevin McCarty responded to similar comments Rep. Royce made in an earlier letter, saying that, "the NAIC as an association does not have regulatory authority, but its members do," and that the decision to implement the NAIC's standards and best practices "remains with the individual states."[47]

To be clear, we are not saying that the NAIC should not try to improve state regulation through efforts such as its accreditation process or providing specialized services to the states.

One can note that the NAIC is already subject to oversight by hundreds of entities and individuals—more than 50 state regulators, more than 100 state legislatures, federal and international regulators, the Government Accountability Office and other federal agencies, and others. However, the situation here is akin to the sight-impaired men and the elephant. While many people see a part of the NAIC, no one outside it can see everything about it. As the NAIC's operations continue to expand with its Big Data and other initiatives, **Congress should empower some entity to continuously monitor the NAIC's operations and periodically report back to Congress.** The most important and effective improvements in state insurance regulation over the years have come when the federal government has threatened the states' regulatory primacy.

State Authority Over Insurance Groups Is Limited

Insurance companies often set up subsidiary companies in each state in which they do business, and state regulators oversee the financial condition of the subsidiary domiciled in their own states. But while state regulators have a good track record of ensuring the solvency of the companies domiciled in their states, they have only limited authority over transactions within multi-state insurance groups.

FSOC's non-bank SIFI designation process, which subjects designated companies for oversight by the Fed Board, was a policy response to fill the perceived gap in group supervision. The NAIC has taken a "windows and walls" approach to group supervision, most recently making changes in its Solvency Modernization Initiative (SMI). This approach emphasizes "windows" for regulators to look at activities within an insurance group in other states, and the ability to "wall" off insurance capital from any non-insurance activities in the insurance group. The NAIC also has revised its model holding company law and proposed a model procedure for risk management.[48] This includes the ability of states to request and acquire consolidated financial reports, to require enterprise risk reports for an insurance group, and to enable participation in supervisory colleges.[49]

In 2014, the state of New Jersey went further, adopting legislation that authorizes the New Jersey Commissioner of Banking and Insurance to be the group-wide supervisor for IAIGs headquartered in that state.[50] The legislation even gives the commissioner the authority to act as a group supervisor for IAIGs with substantial operations in New Jersey but headquartered in other states, under certain conditions. However, it is unclear how insurance regulators in other states would respond to New Jersey attempting to exert its authority over subsidiaries domiciled in their states.

The International Monetary Fund's 2015 assessment of U.S. insurance regulation reported that states were making progress under the SMI but that changes are "a work in progress" that still face obstacles.[51]

We agree that progress has been made. However, states face inherent structural challenges in supervising globally active insurance groups and, in fact, have a strong incentive to focus on protecting only those policyholders in their own states. Absent a binding interstate agreement, a federal role in group supervision could augment state oversight for insurance groups that serve customers in more than one state. However, as we will explain in greater detail in the sections below, SIFI designation is not the ideal way to achieve this oversight.

Adjusting the Federal Role in Insurance Regulation

In many ways, the mere prospect of greater federal oversight of the business of insurance has improved state regulation. Law professor Susan Randall noted in 1999 that over time, the NAIC had achieved, "sufficient uniformity to head off threats of federal control without unduly sacrificing state regulatory primacy. In the early days of insurance regulation, the NAIC's standardizing role substituted for the national government. In the recent past, states have preserved their regulatory dominance by ceding some measure of autonomy to the NAIC—a collection of state officials—in lieu of the federal government. When the threat of federal intervention recedes, the states tend to reclaim their authority."[52]

This pattern of responding to the threat of federal involvement is evident again in recent history. In light of renewed federal interest in insurance since the financial crisis, state regulators have taken steps to modernize their approach to issues such as group supervision, risk-based capital, and reinsurance collateral. In each case, the threat of federal preemption or encroachment into areas traditionally reserved for states was real and spurred state action. This is not to say that these changes could not have come about without the threat of more federal involvement, but that threat certainly focused the NAIC's efforts.

In early 2017, an NAIC official was quoted as saying the organization would advocate for eliminating FIO, saying, "[o]ur members have come to the conclusion that, while they still think that there should be expertise at the federal level for insurance and there should be people serving in that capacity, the office isn't necessary."[53] We disagree. In fact, we believe that the existence of FIO has made state regulation better and can continue to do so if it is structured correctly.

Chairman Hensarling's (R-TX) 2016 Financial CHOICE Act would turn FIO into an Office of the Independent Insurance Advocate that would be more independent within the Treasury Department, but also take away FIO's current authority to collect insurer data and bar the new agency from participating in supervisory colleges. The legislation would also combine the positions of FIO director and FSOC independent member into a single Independent Insurance Advocate.[54]

We agree that the federal office focused on insurance should be independent, and that the positions of FIO director and FSOC independent member should be consolidated. Both are good-government measures that would make federal government action on insurance more effective and efficient. However, we also believe that FIO can serve as a useful spur for states to continually improve their regulation.

As we have argued above, there is more to be done to improve U.S. insurance regulation. The states should be given the opportunity to implement the recommendations we have suggested. However, there are several changes to enhance the federal role in insurance regulation that Congress should implement in the near future.

Immediate Changes to Federal Insurance Regulation

Better Rationalize FIO

Congress should either elevate FIO to a bureau within the Treasury Department similar to the Office of the Comptroller of the Currency (OCC), which is housed at Treasury but independent of it, or make it an independent agency outside of Treasury.[d] While the agency would still not have regulatory authority, except in unusual circumstances, FIO's capacity for helping to develop smart policy recommendations would benefit from greater independence from Treasury and a degree of insulation from the political process.

To effectively fulfill the responsibilities we envision for FIO, the agency needs to have sufficient resources available to it. **We recommend that Congress grant FIO the ability to assess U.S. insurers, proportional to the amount of domestic premiums each insurer writes, for its funding.**

[d] This would include adding the FIO director to the list of independent financial regulatory agencies in 12 U.S.C. Section 250.

Merge the Functions of the FIO Director and FSOC Independent Member

Congress decided it was important for a voting member of FSOC to have knowledge of the business of insurance. However, since there is no federal insurance regulator and giving FIO a vote on the Council effectively would have given the Treasury Department two votes, Congress created a separate position for an independent member with insurance expertise.[55]

This bifurcation of the federal insurance role has led to unnecessary confusion on areas of mutual concern. For example, the independent member was granted observer status at the IAIS, which allowed the independent member to access non-public materials and to comment on its work. However, the IAIS voted later that year to end observer status for all non-members. That decision resulted in the independent member—who is charged with voting on whether to designate U.S. insurers as SIFIs—no longer being able to participate or observe the global body tasked with determining a framework for designating systemically important insurance companies.

Making FIO an independent agency removes the problem of the Treasury Department having two votes on FSOC and leaves no reason not to combine these two positions into one. **We recommend that leadership of the merged FIO be vested in a director with a six-year term who would be appointed by the president and confirmed by the Senate.** These are the same parameters that currently apply to the independent member, as well as the director of the OFR and the directors of the Federal Deposit Insurance Corporation and the National Credit Union Administration. Currently, the FIO director is selected by the Treasury secretary.

Congress also should allow FIO directors to serve beyond their term in office until a successor is appointed and confirmed by the Senate. Dodd-Frank did not include such a provision for the FSOC independent member, making that position one of the few Senate-confirmed financial regulators without such a provision. Taking this action would allow for greater continuity at FIO in the event that the nomination or confirmation of a successor is delayed.

Finally, after merging the position with FSOC's independent member, **Congress should make the FIO director a voting member of FSOC.**

Monitor State Regulation

In addition to the authorities it now has, FIO should be authorized to exercise oversight of the NAIC and report to FSOC and Congress on the NAIC's activities. This would not give FIO the authority to regulate or otherwise control the NAIC or state insurance regulators. It would, however, be useful to permanently establish a federal agency with insurance expertise to regularly update policymakers on the condition of state insurance regulation.

Congress has already created a model for this role for FIO in statute. Dodd-Frank required FIO to submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States. The resulting report, named exactly as the statute suggested, contained numerous recommendations to improve state insurance regulation without giving FIO the authority to require those changes.[56]

We recommend that Congress require an annual report from FIO on the activities and governance of the NAIC and state insurance regulation, and that it hold hearings on each report with the FIO director and a state insurance regulator chosen by the NAIC.

Make NAIC Policymaking More Transparent

The NAIC should adopt standards similar to the federal APA and the Government in the Sunshine Act to ensure greater transparency in policymaking. Closed meetings are appropriate when proprietary or confidential information is discussed. **Further, the NAIC should consider whether its accreditation process could be made more meaningful by directly using independent third-party audits as the basis for whether states should attain or retain their accreditation.**

Develop a More Formal FSOC Process for Insurers

As the designated voice on FSOC with insurance expertise, FIO should take a more prominent role in decisions of whether FSOC should designate or de-designate insurance companies as SIFIs. Currently, Dodd-Frank allows FIO or the Fed Board to issue written recommendations on whether to designate insurance firms as SIFIs either upon request by FSOC, or on their own initiative.[57] **We recommend that Congress amend Dodd-Frank to require that FSOC seek a formal opinion from FIO in each case in which an insurer is being considered for designation or de-designation.** In the meantime, **FSOC should request such a formal opinion on its own in all such cases.**

Currently, FSOC may designate a company if the Council "determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."[58] In other words, FSOC may designate if the firm's distress could be a threat to financial stability, or if the firm's characteristics could be such a threat.

FSOC has used the first criterion for all four of its designations to date. In his dissent in the 2014 vote to designate MetLife, Inc. as a SIFI, FSOC's independent member suggested that FSOC did so at least in part because, "it is easier to simply presume a massive and total insolvency first, and then speculate about the resulting effects on activities, than it is to initially analyze and consider those activities."[59]

Crises are generally caused by activities and products for which regulators and market participants either missed or misjudged the level of risk they posed. A case for the first designation criterion can be made on that basis: that regulators cannot predict every way a financial firm could become distressed. However, there is much that can be assessed about a firm's vulnerability to distress and, hence, the need for designation. Therefore, **we recommend that FSOC be required to assess a firm's vulnerability to material financial distress before it designates—or de-designates—a non-bank SIFI.**

Improve State-Federal Coordination

To promote better coordination among federal and state policymakers and to help address current conflicts in insurance regulation between federal and state jurisdictions, Congress should require FIO to **establish an advisory committee composed of state regulators chosen by the NAIC.** The director of FIO should meet regularly with this group and seek their counsel on any important matters within the purview of both FIO and state regulators, including FIO's oversight of the NAIC. To further improve federal cooperation, a member of the Fed Board should be included on the committee.

Streamline the Process for Appointing NARAB Board Members

The National Association of Registered Agents and Brokers Reform Act of 2015 (also known as NARAB II) mandated that a national clearinghouse be created to simplify licensing for the roughly 2 million U.S. insurance agent and brokers. Over the years, progress has been made to create uniformity in such licensing, but a number of states did not adopt legislation to make it reciprocal with other states. NARAB II created an independent, non-profit corporation with a board of directors to fulfill the legislation's purpose to provide "a mechanism through which licensing, continuing education, and other nonresident insurance producer qualification requirements and conditions may be adopted and applied on a multi-state basis without affecting the laws, rules, and regulations, and preserving the rights of a State."[60]

The NARAB II board, which was created to help implement this legislation, is to be made up of 13 directors—eight current or former state insurance commissioners and five insurance industry representatives—appointed by the president and confirmed by the Senate.[61] The law mandated the board be fully appointed within 90 days of enactment, but President Obama did not begin to make nominations until January 2016. The president made ten director nominations, all of which were allowed to lapse at the end of 2016 by the Senate.

As BPC has shown, the nominations process for financial regulators has broken down since the late 1980s. The process for nominating and confirming people to these positions has more than tripled during that time.[62] The directors of NARAB are important positions, but not so critical that they should require a process that requires Senate confirmation.

We recommend that members of the NARAB board be appointed by the president without requiring Senate confirmation. For the eight current or former state insurance commissioners, the president would choose from a list of 16 provided by the NAIC. The president would choose the five industry representatives after consulting with the NAIC.

Promote a Well-Functioning Market for Cyber Insurance

The market for cyber insurance, a product that did not even exist before the mid-1990s, is booming.[e] Some experts estimate that premiums will increase to $7.5 billion by 2020.[63] High-profile attacks on confidential customer data and prominent companies have raised concerns about the integrity of the personal data entrusted to firms and government agencies. These cyber incidents also raise alarms among policymakers and regulators, who understand that the attacks threaten economic activity, financial markets, and U.S. national security.

The central obstacle to a robust, well-functioning cyber insurance market is the inability of both insurers and insureds to know exactly how much risk is involved in cyber attacks. The difficulty in underwriting cyber insurance means that the supply and demand for insurance coverage may be significantly mismatched to actual risk. If insurers underestimate the risk they are insuring, they may face heavy losses for one or more insurable events. On the other hand, if they overestimate the risk they are insuring, they may not offer enough insurance to meet demand or offer it at excessive premiums that deter potential customer from purchasing the coverage needed to mitigate risk.

[e] For a more detailed discussion of the state of the cyber insurance market, see: Bipartisan Policy Center, "Cyber Insurance: A Guide for Policymakers," March 2016. Available at: https://bipartisanpolicy.org/wp-content/uploads/2016/03/BPC-Cyber-Insurance-Guide.pdf.

It is important to consider what form the market for cyber insurance will take. Policymakers and insurers are focused on learning how to adequately understand the risk of insuring against cyber attacks and how to model the likelihood of future losses.

If these obstacles cannot be sufficiently overcome, some kind of government backstop may be required to cover catastrophic, correlated losses that the insurance industry simply cannot absorb. In the absence of such an event, **we recommend that policymakers focus on how to overcome the obstacles in the way of a fully functional market for cyber insurance.** This should include improving the collection and sharing of high-quality data on cyber incidents; standardizing terminology, policy language, and best practices for cyber hygiene; and ensuring that legislation to address cyber insurance is technology-neutral, to allow it to adapt to future technologies that cannot be anticipated.

Recommendation to Improve State Supervision of Insurance Groups

Consider a State Compact

Despite progress made to improve the ability of states to supervise insurance groups, questions remain about how a conflict would be resolved if a state insurance commissioner with jurisdiction for the insurance group's holding company were to ask the holding company to take action that could disadvantage the policyholders of one of the group's subsidiaries in another state.

One option to address this would be to **pursue a compact to provide for coordinated supervision of insurance groups.** Interstate compacts, which are binding agreements between two or more states that operate like a contract, are a means for standardizing certain features of insurance regulation. In other words, the material terms of a compact must be the same in each state that is a party to the compact. An interstate compact requires congressional approval if the compact authorizes participating states to exercise a power they could not exercise in the absence of the compact and if the compact delegates sovereign power to an interstate commission. Thus, if a compact delegates oversight and enforcement to a body, such as the NAIC, the compact may have to be approved by Congress. In approving a compact, Congress could mandate that the federal government be a party to the compact or could impose some directions or requirements upon the participating states.

Options for Future Federal Involvement

Together, the foregoing recommendations will enhance FIO's ability to aid federal policymakers while retaining the primacy of the state insurance regulatory system. However, if material progress is not made on other needed improvements in state oversight within a reasonable period of time—perhaps during the next four years—Congress should consider additional federal involvement.

At least two approaches are worth considering: an OFC and minimum federal standards. **To be clear, we are not calling for either of these approaches at this time. We would prefer that states continue to be the primary regulators of insurance.** However, if states do not allocate sufficient resources for supervision and are not able to align behind more unified standards, an enhanced federal role may be necessary to protect policyholders and the solvency of insurers.

Optional Federal Charter

An OFC would permit an insurer to select either state or federal regulation, depending on its strategy and business plans for meeting the insurance needs of its customers. This approach is modeled on the dual banking system, which has allowed banks to select either a federal or state charter for more than 150 years.

Proponents of an OFC have made their case on a number of grounds, including that:

- State insurance regulation is inefficient and costly because it forces insurers that do business in multiple states and operate with a national strategy to comply with different rules and regulations in numerous states and jurisdictions. An OFC would centralize overall regulatory oversight and make it more consistent for such companies with national or multistate scope and strategies;

- A federal insurance regulator would provide the federal government with greater knowledge about the business of insurance, which makes up a substantial share of U.S. economic activity and can impact other sectors of the economy;
- A federal regulator should be better able, and have more incentives, to supervise insurance groups—groups of companies that include at least one insurer and at least one other company that "has significant influence on the insurer"[64] —as a consolidated entity rather than each subsidiary of the group separately, allowing such a regulator to see broader problems in an insurance group that state regulators focused on insurer subsidiaries in their own states might miss;
- The federal government would have more resources available to handle unexpected crises; and
- An OFC would promote national competition and lower prices for consumers.

Over the years, legislation has been introduced in Congress to create an OFC, including the National Insurance Act of 2007, co-sponsored by Sen. John Sununu (R-NH) and Sen. Tim Johnson (D-SD),[65] and the National Insurance Consumer Protection Act, introduced in 2009 and co-sponsored by Rep. Melissa Bean (D-IL) and Rep. Edward Royce (R-CA).[66] The 2008 Treasury *Blueprint* recommended an OFC and federal insurance regulator,[67] while a 2009 Government Accountability Office report suggested that Congress "explore the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity."[68]

OFC opponents have responded in a number of ways, including that:

- State-based insurance regulation has worked well, and adding a layer of federal bureaucracy would be confusing for policyholders and markets and create overlapping and duplicative regulation;
- An OFC would increase the potential for regulatory arbitrage that would lower overall regulatory standards;
- States are better-equipped to protect policyholders because they are focused on and more responsive to consumers in their own states;
- Diversity in state regulation reduces the potential impact of bad regulation and promotes innovation; and
- States could lose significant revenues if many insurers chose an OFC.

There are reasonable arguments on both sides of this debate. However, if Congress were to find it advisable to authorize an OFC, then we recommend the following approach to maximize its benefits while minimizing potential downsides.

Create an Independent Insurance Solvency Regulatory Agency

For a financial regulatory agency to be effective, it should have enough independence and authority to pursue its congressional mandate while also being accountable for its actions.

Elevating FIO to an independent agency, the better alternative, or an autonomous bureau within the Treasury Department is necessary to create this balance. In addition, under an OFC, **we recommend that this "new FIO" would be the chartering authority and primary solvency regulator for insurance companies that opt for a federal charter, including the operating companies of SIFI insurers.** This would establish a system in which insurance companies are overseen by an agency and personnel with primary expertise in insurance supervision and regulation, as they are at the state level.

We recommend that the Fed Board should oversee insurer holding companies that include insured depository institutions, consistent with current law. The new FIO should oversee insurance holding companies without insured depositories.

Independent funding allows an agency to make difficult but necessary decisions that are free from undue political influence. Therefore, **we recommend that the new FIO be funded by assessments on the companies it oversees**, which is how the OFR, the OCC, and other agencies fund themselves. Funding through assessments does leave the potential for companies to engage in regulatory arbitrage, which also is a risk for state regulators. **Assessments should be proportional to the domestic premiums written by assessed insurers.**

Keep Market Conduct Oversight with States

State insurance regulators handle vastly more consumer inquiries and complaints than the banking system,[69] and for the most part do it well. This is in large part because consumers with problems are more likely to get responsive service from someone closer to where they live. We do not see any compelling reason to shift market oversight to the Consumer Financial Protection Bureau (CFPB) or another federal agency, and this is a matter about which many consumer advocates and insurers agree. Therefore, **we recommend that consumer protection and other market conduct oversight of insurers that opt for a federal charter be left in state hands**, subject to the improvements we recommended earlier in this report.

No Rate Regulation

In line with our earlier recommendation and the principle that premiums should be actuarially sound, **insurance companies that opt for a federal charter should not be subject to rate regulation.** This is especially critical if the solvency regulation rests with the federal government and market regulation remains with the states. It would be too tempting for the states to suppress rates if they knew that the federal government would have to deal with any negative financial fallout that results from doing so.

Mandatory for SIFI Insurers

Later in this paper, we recommend taking an approach that emphasizes the regulation of risky activities and products ahead of the current process for designating non-bank financial firms as SIFIs. Although we believe that to be a superior approach, SIFI designation today is the primary tool FSOC has to address systemic risk.

If Congress decides to create an OFC, then the agency that manages that charter would be best equipped to oversee insurer SIFIs as well. Therefore, **we recommend that any SIFI insurers be required to opt for a federal charter.**

Minimum Federal Standards

An alternative to an OFC would be to allow a federal entity to apply federal minimum standards to certain areas of state insurance regulation. Under this approach, the federal government would design a mechanism to set minimum standards that each state would be required to meet. Individual states could choose to go beyond that minimum level. Essentially, the effect would be similar to what the NAIC's accreditation process was designed to accomplish, but the federal government would have the legal standing to effect those standards in a way the NAIC cannot. States enforcing federal standards can be seen in the way Medicare supplement policies are regulated.

In 2004, Rep. Michael Oxley (R-OH) and Rep. Richard Baker (R-LA) drafted a federal standards bill called the State Modernization and Regulatory Transparency Act, or SMART Act. That bill, which was never formally introduced, would have set federal standards on licensing, market conduct, rate regulation, policy forms, and other matters, and it would have required the states to adhere to those standards within three years following enactment.[70]

Federal minimum standards have long been used to try to change state policies. However, to avoid constitutional challenges, such standards must not "coerce" or force state action. A federal statute that links federal funding to state compliance with certain conditions may be permissible. For example, in the 1970s, states were required to agree to a 55 mile per hour speed limit as a condition for receiving federal highway repair funds.[71]

Similarly, a statute that gives states the choice of regulating an activity according to the federal standards or having state law preempted by federal regulation would be allowed. Congress took the latter approach in Dodd-Frank with regard to covered insurance agreements, which can preempt state insurance measures in certain narrow circumstances.

In addition, as a practical matter, it would be important to create a mechanism to oversee consistent enforcement of the federal standards. Otherwise, individual state interpretations of the standards could undermine the goal of consistency. FIO would be an obvious agency in which to vest the authority to ensure compliance.

One area for which minimum federal standards would make sense is in regulating systemically risky activities and products. As we argue elsewhere in this report, an activities-and-products-based approach would be preferable to designating individual firms as SIFIs. There are, however, at least two obstacles.

First, FSOC only has the power to recommend, but not require, action on activities and products that could threaten financial stability. Second, Congress could empower FSOC to compel action. Giving FSOC the authority to set minimum federal standards on systemically risky activities and products would address these problems. Therefore, we make the following recommendations.

Authority to Set Minimum Federal Standards on Risky Activities

Congress should give FSOC the authority—after FSOC has consulted with the independent member with insurance expertise, the director of FIO, and the non-voting state insurance commissioner member and after FSOC determines under Section 120 (a) of Dodd-Frank that more stringent regulation of a financial activity is called for due to financial stability concerns—**to direct FIO to set minimum federal standards to sufficiently address the risk posed by that activity.** If states do not adopt those standards within a reasonable period of time, set by FIO in consultation with the NAIC and with other members of FSOC, then the minimum standards would preempt state insurance measures if they are in conflict with the standards.

If Congress were to move forward with minimum federal standards more generally—outside the context of systemic risk—the question would be how and when to apply them. **One approach would be to trigger FIO's ability to set standards when the NAIC's membership votes to make a provision a part of its financial accreditation standards.** In effect, this would allow FIO to enforce the NAIC's accreditation standards in a way that the NAIC cannot today, while still leaving the ultimate choice about whether to adopt standards to the states. In such cases, **FIO should work with the NAIC to define parameters that meet the standards that the NAIC's members approved and allow states to develop standards within those boundaries.** This approach would address issues where most states adopt a standard but one or more key states do not, leaving a significant gap in state-to-state uniformity.

Systemic Risk and Insurance

The financial crisis led to Dodd Frank, which extended federal oversight of the insurance industry in the interest of ensuring the stability of the financial system.

In particular, the near collapse of insurer AIG made clear that an insurance company can threaten financial markets. Although the sale of credit default swaps (CDS) outside its traditional insurance business was the largest contributor to AIG's problems, securities lending by its insurance subsidiaries was also a major issue.[72] Further, while CDS were not traditional insurance products and the New York State Insurance Department issued an opinion in 2000 that a CDS transaction did not qualify as insurance in most circumstances,[73] CDS do insure against the default of a security.

The consensus, however, is that traditional insurance activities and products are much less likely to present systemic risk than banking or certain other financial services. Temple University professors J. David Cummins and Mary A. Weiss in 2010 argued that the factors that contribute to systemic risk are leverage, liquidity risks and maturity mismatches, complexity, and government policy and regulation,[74] which generally present lower risks for insurers than banks.

P/C insurance, in particular, is unlikely to threaten financial stability, in part because it is a business with low leverage. In addition, P/C policies do not have "optionality," or the ability for policyholders to "cash out" their accounts on demand. Instead, insurers only pay out claims when an insurable event occurs, so those firms are not susceptible to economic shocks the way banks are.[75] P/C policies are short-term, often for 12-month periods. If underpriced, an insurer can adjust to the risk after a year. And in cases where the P/C industry has experienced shocks, such as after Hurricane Andrew in 1992 and during the liability insurance crisis of the 1980s, those problems did not have a major impact on the real economy.[76]

There is more debate about whether life insurance can threaten financial stability. New York University professors Viral V. Acharya and Matthew Richardson in 2014 argued that the "traditional" insurance sector is no longer so traditional and thus presents more systemic risk than it once did because life insurers:

1. Offer products with non-diversifiable risk, such as products with minimum guarantees that expose insurers to equity and other investment markets;
2. Are more prone to runs because of the growth of insurance company liabilities that are able to be cashed out at the policyholder's option;
3. Insure against losses due to macroeconomic events—such as the failure of the housing market prior to the last crisis—leaving insurers prone to transfer their own distress to their counterparties in the financial system; and
4. Have expanded their role in financial markets, blurring the line between traditional insurance activities and other financial activities, such as securities lending.[77]

Law professors Daniel Schwarcz and Steven L. Schwarcz in 2014 pointed to insurers being "the largest institutional investors in debt securities" and corporate funding. They argue that the industry's investments could be procyclical, leading to asset price bubbles in good economic times and fire sales at a time when distressed insurers are forced to liquidate assets. The authors also say that insurers are increasingly part of financial conglomerates, making it easier for distress to damage other financial firms within the company.[78]

On the other hand, Wharton School professor Scott Harrington maintains that life insurance presents "much lower potential for systemic risk" than banking does. While granting that life insurance is more systemically risky than P/C, he argues that "shocks to life insurers do not threaten the economy's payment system and short-term lending" as banks do, and that the insurance industry has faced strong market discipline, held more capital than regulation has required, has not faced the incentives for evading regulation that banks have, and that insurance activities in general are not as risky as bank activities.[79]

The Geneva Association, an insurance industry think tank, has identified two non-core activities through which insurers could generate systemic risk: derivatives trading on non-insurance balance sheets—which would include CDS trading—and the mismanagement of short-term funding raised using commercial paper or securities lending, as a source of liquidity risk. The Geneva Association also argues that traditional insurance presents no systemic risk, and in fact helps stabilize the financial system, in part because insurance is funded through up-front premiums, which allows insurers to fund themselves without accessing short-term wholesale funding like other financial firms do. Further, insurance policies are longer-term in nature, paying claims only when an insurable event occurs, and those events are, in general, actuarially predictable. Because of that, insurers do not face run risk like banks and certain other non-bank financial firms do.[80]

For its part, FSOC has cited products like variable annuities that offer minimum financial guarantees that put more risk from equity price and interest rate fluctuations onto insurers.[81] And FSOC has cited a number of factors that led to its three insurer designation decisions, including the potential for fire-sale dynamics, the exposure of policyholders to losses, the possibility that state guaranty associations would be unable to handle a large-scale failure, and a lack of consolidation supervision by state regulators.[82]

We find the view that traditional P/C insurance is not systemically risky to be persuasive. Further, we believe that life insurance can present some systemic risk, but at a much lower level than banking and certain other non-bank financial services. In general, the degree to which insurers are systemically risky depends on the degree to which they offer risky nontraditional products and services, and how they manage those risks. As we explain in the next section, this is a good reason why an approach that focuses on risky activities and products would be a better way to address systemic risk than designating large insurers as SIFIs.

Insurance and SIFI Designations

FSOC's process for designating systemically important non-bank financial institutions has been subject to criticism and ongoing litigation. FSOC decided to designate three insurers as SIFIs, although FSOC's independent member with insurance expertise, Roy Woodall, voted against designation in two of those cases.[83] One of the three SIFIs successfully sued to have its designation removed, on the grounds that FSOC's decision to designate was arbitrary and capricious. That case was under appeal at the time this report went to press. Given the Trump administration's shift toward a more deregulatory stance in finance, and its intent to review Dodd-Frank, it would not be surprising if the administration were to drop this appeal at some point.

In any event, an industry petition asked FSOC to amend its designation rules to improve the scope and quality of the data and information available to it, improve the notice provided to a non-bank financial company being considered for a proposed or final determination, and ensure that primary financial regulatory agencies are afforded a meaningful opportunity to participate in any proposed or final determination.[84] The process has been criticized as too subjective and, despite steps taken by FSOC to improve its transparency,[85] still too opaque. These criticisms have prompted legislation to revise, or even eliminate, FSOC's designation authority.

An additional criticism of the SIFI process is that designation has a number of practical limitations when it comes to addressing systemic risk:[86]

1. Designation is an either-or decision. FSOC cannot designate every large non-bank financial firm, meaning the process is always going to be partially subjective. There is no magic threshold above which a firm suddenly becomes systemically risky, while firms below the threshold are not. Yet, designation creates a separate class of SIFIs that are subject to substantially more regulation and oversight than the non-SIFI firms with which they compete, rather than having oversight ramp up to match a firm's risk profile.
2. Designation is a cumbersome, lengthy process. Since FSOC should be deliberate in these decisions, slow is not necessarily bad. But the process is not designed to allow FSOC to react quickly to emerging threats.
3. If a firm restructures itself to attempt to escape its SIFI designation, it is not clear that the overall market will become less risky. Instead of reducing risk, designation may simply shift risk within the financial system. As the firm makes divestments, closes units, and unwinds certain operations, that risk may go somewhere else.

Despite these limitations, FSOC has designated three insurers. This may be in part because SIFI designation is the only substantial authority Congress granted FSOC to address systemic risk.

However, financial crises generally result not so much from risky individual firms, but from risky activities and products that are present across a range of firms. The 2007-8 crisis, for example, came about largely because of a housing price bubble that was inflated by risky activities like excessive leverage at financial firms and poor mortgage underwriting, and from risky products like CDS that also were poorly underwritten.

Dodd-Frank gives FSOC a mechanism to "provide for more stringent regulation of a financial activity" if it believes that activity or practice could spread financial instability among U.S. financial markets, financial firms, or low-income, minority, or underserved communities.[87] However, this authority is only to recommend action by a regulatory agency; FSOC itself cannot require that action.

Congress was right to assign FSOC and the OFR the task of monitoring U.S. financial stability and addressing systemic risk. However, **public policy would be better served to give FSOC more meaningful authority to address risky activities and products than to focus on SIFI designations.** One way Congress could accomplish this would be through minimum federal standards, which we discuss in this report under *Options for Future Federal Involvement*.

Federal Insurance Regulation Must Be Tailored to the Business of Insurance

The Federal Reserve, which had little historical experience with insurance regulation before Dodd-Frank, has since gained some degree of oversight of about one-fifth of the U.S. life and P/C insurance industries.[88] This led to fears that the Fed Board would try to apply bank-like rules to insurance companies, or that it would not devote sufficient resources or priority to the oversight of the insurance firms within its jurisdiction.

The Federal Reserve has since hired a number of people with insurance expertise, and while the agency's initial proposal on a capital standard for insurers was criticized by some, the proposal and the Fed Board's approach has generally been seen as nuanced and thoughtful. It is difficult to judge the Federal Reserve's oversight of insurance so far because the agency has been slow to implement new rules and regulations in that area.

It is important that the Federal Reserve continue to pursue a policy toward insurers within its jurisdiction that is tailored to the business of insurance. This includes the capital standards the Federal Reserve is in the process of developing for the insurers within its jurisdiction.

Global Insurance Regulation

International coordination of policymaking is important, but global agreements on insurance regulation must also work well with U.S. goals and standards, including for policyholder protection. Policymaking at international bodies has been uneven to date, and transparency could be improved.

International Negotiations Are Complicated by Multiple Voices

"Who do I call if I want to speak to Europe?" Henry Kissinger is supposed to have said this and, although the story is likely apocryphal,[89] the sentiment sums up the frustration that U.S. policymakers have had in dealing with multiple European jurisdictions over the years (a problem which could be aggravated if the EU weakens or even disbands in upcoming years, given the backlash against it in some countries). The same frustration is felt by some foreign governments in dealing with the 56 states and jurisdictions that comprise the U.S. state insurance regulatory system.

Representing a U.S. position on insurance regulatory matters in a global setting has long been problematic. There is no single voice that has been able to represent the United States on insurance regulatory matters at a global level because the U.S. system is a loose collection of 56 different jurisdictions. As insurance has become a more global business, this lack of coordination has become more relevant and problematic.

Congress attempted to address the issue in Dodd-Frank, but the addition of several federal seats at the table did not solve the difficulty the United States has in putting forth coordinated positions on insurance regulatory matters. Table A summarizes the key activities and limitations of each participant.

Table A: U.S. Entities Involved in Global Insurance Regulatory Issues

Status	NAIC	Federal Reserve Board	Treasury Department	FIO (office within Treasury)	Independent FSOC Member
Regulatory authority?	Yes (supervision and regulation of all U.S.-based insurers)	Yes (SIFIs & SLHC insurers)	No	No	No
FSB member?	No	Yes	Yes	No	No
IAIS member?	Yes	Yes	No	Yes	No
IAIS Executive Committee member?	Yes	No	No	Yes	No
FSOC member?	Non-voting	Voting	Voting Chairman	Non-voting	Voting

FIO was explicitly given the authority in Dodd-Frank "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States"[90] internationally on certain insurance issues and to negotiate covered agreements with foreign jurisdictions. However, FIO has no domestic regulatory authority.

State insurance regulators conduct most of the insurance oversight in the United States and have been doing so for nearly 200 years. However, each state can go its own way, and the NAIC does not have the authority to regulate or speak for all of its members, nor to compel its members to adopt its policies or model legislation and regulations. State regulators also have historically focused on oversight of insurance companies and their activities only in their states and not on the operations of insurance groups as a whole. Meanwhile, other countries can find it difficult to accept subnational governments as national representatives.

The Federal Reserve Board has global stature and the trust of foreign banking regulators and now has partial regulatory authority over several of the largest, most complex U.S.-based insurers. However, the Fed Board shares that authority with state regulators and is just beginning to build its knowledge and expertise in the business of insurance, having been a banking supervisor and regulator for its entire history prior to the passage of Dodd-Frank. The Fed Board also has many other international responsibilities and priorities in monetary policy and bank regulation that compete for its attention and resources. Adding insurance to a full and complicated mandate seems more than challenging, particularly while the Fed Board is still attempting to learn more about the business of insurance.

The U.S. system of insurance regulation is further fragmented in the oversight of potentially systemically important insurance companies. FIO, the Fed Board, and the NAIC all sit on the IAIS, which develops the methodology to assess G-SIIs. The Fed Board and the Treasury (of which FIO is a part) sit on the FSB, which designates G-SIIs. The NAIC is not represented on the FSB. Further, the FSOC independent member with insurance expertise, who votes on whether to designate U.S.-based insurers as SIFIs, has no voice on any international insurance body. This does not aid U.S. credibility in global insurance forums.

FIO, as noted above, does not have regulatory authority, and it cannot force states to act. Further, the Fed Board, which regulates insurer SIFIs and insurers affiliated with a savings and loan, is also represented on numerous international regulatory bodies. And FSOC's independent member does not participate directly in global forums, but does vote on domestic U.S. matters with global implications, such as the designation and de-designation of insurer SIFIs. Taken together, these dynamics make it difficult for the United States to have a coordinated and united position on insurance regulatory matters in international discussions.

Three U.S. insurance regulatory entities—the NAIC, FIO, and the Fed Board—are now members of the IAIS, and no mechanism exists to ensure that they take a common perspective on supervisory and regulatory matters. Similarly, the FSB has assumed a prominent role in setting insurance standards globally, but only the Fed Board is represented on that body, and the states and FIO have no formal means to influence the positions taken in FSB deliberations.

These issues have shown their relevance in recent months.

In January 2017, House Financial Services Committee Vice Chairman Patrick McHenry (R-NC) sent a letter to Fed Board Chair Janet Yellen demanding that the Fed Board stop negotiating international financial regulatory standards until the Trump administration "has had an opportunity to nominate and appoint officials that prioritize America's best interests." McHenry argued that federal regulators had negotiated global agreements in secret that had harmed U.S. economic growth.[91]

Several days later, these claims were in part echoed in a White House executive order laying out the Trump administration's core principles for regulating the U.S. financial system. Among the order's seven core principles were to "advance American interests in international financial regulatory negotiations and meetings" and to "enable American companies to be competitive with foreign firms in domestic and foreign markets."[92]

In response to McHenry's letter, Yellen said that these global agreements are not binding on in the United States, but must instead be implemented by U.S. regulators, who had often adopted different standards "to better reflect the nuances of U.S. financial institutions and markets." She further argued that global coordination had helped the U.S. economy by fostering financial stability and in placing U.S. financial firms on a level playing field with their international competitors.[93]

Global negotiation on bank regulatory standards—such as those worked out through the Basel Committee on Banking Supervision—has a longer and more comprehensive history than on insurance regulatory standards. However, the most recent financial crisis led the FSB to raise the profile of the IAIS as a forum to coordinate global standards. U.S. regulators have engaged on a number of efforts:

ComFrame and Internationally Active Insurance Groups

The IAIS has published a list of Insurance Core Principles (ICPs), a set of globally accepted statements, standards, and guidance that provide a framework for supervising the insurance sector and ensuring it is financially sound and protects policyholders.[94] As part of its Financial Sector Assessment Program, the IMF and the World Bank conduct periodic reviews of individual countries' observance of ICPs and issue assessments of a country's insurance supervisory regime.[95]

In 2010, the IAIS began developing a framework for the effective group-wide supervision of IAIGs, called the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The IAIS describes an IAIG as "a large, internationally active group that includes at least one sizeable insurance entity," and has provided criteria for determining which insurance groups should be considered IAIGs:

1. They must be internationally active, writing premiums in at least three jurisdictions, and at least 10 percent of premiums must be written outside their home jurisdictions.
2. They must be large, with either total assets of at least $50 billion or gross written premiums of at least $10 billion.[96]

However, the IAIS does not designate IAIGs. Instead, the supervisory college for each insurance group uses the IAIS criteria to decide whether the group should be treated as an IAIG. These supervisory colleges are composed of the regulators from the various jurisdictions in which the group operates. ComFrame is intended to ensure greater coordinated group-wide supervision of the company to address the specific challenges IAIGs pose to national regulators and supervisors.

Designation of Globally Systemic Insurers

Following the crisis, the FSB asked the IAIS to develop a methodology for identifying G-SIIs, those "insurers whose distress or disorderly failure, because of their size, complexity, and interconnectedness, would cause significant disruption to the global financial system and economic activity."[97] G-SIIs are a subset of the largest and most complex IAIGs.

While the IAIS developed a way to assess the systemic importance of insurers, the FSB retained the authority to designate individual companies as G-SIIs. The FSB also has proposed that G-SIIs be subject to extra policy requirements, including resolution planning, enhanced group-wide supervision, and higher levels of capital to absorb losses.[98] These extra standards, however, must be imposed by a company's home country.

In June 2016, the IAIS published its updated methodology for designating G-SIIs.[99] The methodology, which is similar to the one used by the Basel Committee to designate global systemically important banks, quantitatively and qualitatively assesses systemic risk in five categories:

1. Size (total assets and revenues);
2. Global activity (revenues derived outside of an insurer's home country and number of countries);
3. Interconnectedness (counterparty exposure and macroeconomic exposure);
4. Asset liquidation (short-term funding, turnover, liability liquidity, non-policyholder liabilities and noninsurance revenues, and highly illiquid assets); and
5. Substitutability (premiums for specific lines of business).

An insurer being reviewed is assigned a "designation score" based on multiple weighted indicators within each category. The interconnectedness and asset liquidation categories make up 85 percent of the weighted score for G-SII candidates. The FSB decides which insurers to designate as G-SIIs based on this score as well as on a separate assessment of business activities, and on supervisory judgment. It is significant that the updated methodology includes provisions to make the process more transparent for the companies under consideration for designation.

The 2016 methodology also removed references to systemic risk arising from non-traditional non-insurance (NTNI) activities. The designation process focuses on certain insurance product features, such as exposure to macroeconomic risks and significant liquidity risks—a stance that is consistent with our recommendation that the SIFI designation process applied to insurance focus on specific activities rather than to entire institutions.

The FSB released its most recent list of G-SIIs in November 2016. The list includes nine insurers, including three based in the United States: AIG, MetLife, Inc., and Prudential Financial, Inc.[100]

Covered Agreement with the EU

A covered agreement is an agreement between the United States and at least one foreign country or regulator on insurance or reinsurance matters that provides similar consumer protection to current state laws. A covered agreement can preempt state insurance measures in certain areas, but only when a state measure treats non-U.S.-based insurers less favorably than U.S.-based insurers, the state measure is inconsistent with the covered agreement, and FIO follows other specified procedures.[101]

In January 2017, U.S. negotiators announced that they had reached a covered agreement with the EU.[102] Key aspects of the agreement include:

1. Reinsurance: Historically, reinsurers based outside the United States have been required to post 100 percent collateral in the United States for loss reserves associated with the risks they reinsure from U.S.-based insurers.[f] U.S.-based reinsurers have been exempt from this requirement. Many outside the United States see the current collateral requirements as a way to give U.S.-based reinsurers an unfair competitive advantage.

The NAIC has argued that collateral requirements exist to ensure assets are available domestically to protect policyholders and the solvency of U.S.-based insurers. In 2011, the NAIC passed changes to its Credit for Reinsurance Model Law and Regulation that would reduce collateral requirements for qualified reinsurers that meet certain criteria. The NAIC reports that most states have or soon will pass a version of the model law, so a covered agreement is not necessary to address this issue.[103]

Under the covered agreement, both parties agree not to impose reinsurance collateral requirements on a reinsurer with a head office or domiciled in the other party's territory that are less favorable than requirements that apply to a domestic reinsurer. These requirements only apply to insurers or reinsurers that meet certain standards, such as on minimum risk-based capital levels.[104]

2. Group supervision: An insurance or reinsurance group domiciled in either the United States or EU will be subject to worldwide group supervision by the appropriate regulatory authority in the country in which the parent company is domiciled. The regulator in the non-home country may not impose a group capital requirement or assessment on worldwide insurance operations as long as the home country uses a group capital calculation that assesses risk for the group, and can take measures to address any problems found in a capital assessment.

3. Equivalence Under Solvency II: Under Solvency II, the EU's new framework for insurance regulation, EU officials decide whether other countries' insurance regulatory regimes are equivalent to the EU's in providing a similar level of policyholder and beneficiary protection, and appropriate supervisory cooperation. If the United States is granted equivalence, U.S.-based insurers will be able to operate in the

[f] Specifically, if 100 percent collateral is not posted, the insurer that buys reinsurance coverage cannot claim credit with regulators for taking out reinsurance, which makes buying reinsurance significantly less valuable.

EU without having to comply with all EU rules, making them more competitive in Europe.

Equivalence can be granted in three areas: group supervision (whether an insurance group and its subsidiaries are adequately supervised), group solvency calculation (whether an insurance group is adequately capitalized), and reinsurance (whether a country's supervision and solvency regime for reinsurance companies is adequate). On June 5, 2015, the European Commission announced that the United States was one of six countries to receive "provisional equivalence" for ten years for group solvency calculation.[105] This provisional equivalence is indefinitely renewable by the EU.

The covered agreement does not explicitly address whether the United States will be granted equivalence, but the agreement addresses each of the areas on which equivalence will be determined by EU officials.

Under Dodd-Frank, the covered agreement cannot go into effect until at least 90 days after the agreement has been submitted to Congress, which happened on January 13, 2017. As this report went to press, the U.S. request was still within that 90-day period. Congress does not need to approve the covered agreement for it to go into effect. The new presidential administration could choose to terminate the agreement, although it has not indicated its intent to do so. In March 2017, the NAIC urged the Treasury Department to seek clarification of some of the agreement's terms to decide whether it is in the United States' best interest and, if it is not, to reopen negotiations.[106] The agreement must also be approved by the European Council and the European Parliament.

States Cannot Bind the United States in International Insurance Negotiations

Although they conduct most of the insurance regulation in the United States, states cannot effectively represent U.S. positions in international negotiations because they cannot bind U.S. policy. In its 2010 assessment of U.S. insurance regulation, the International Monetary Fund (IMF) noted that: "there is a mismatch between the authority reserved to the federal government to enter into international agreements and that of the states to regulate the insurance sector."[107] This is one of the reasons Congress gave FIO and the U.S. Trade Representative the authority under Dodd-Frank to negotiate covered agreements on insurance regulatory matters with other jurisdictions.

Recommendations

Policyholder Protection Should Continue to Be Prioritized

The traditional U.S. approach to insurance solvency has been to first ensure that policyholders are protected when insurers fail at the expense of their creditors and owners. The U.S. system walls off capital in individual subsidiaries to ensure they are protected against failure. A system of state guaranty funds acts as a further backstop to pay policyholders through assessments imposed on remaining, healthy insurers.

Following the financial crisis, regulators have rightly made ensuring financial stability a higher priority. Systemic risk is a major concern in the banking system, but we believe it is much less of a concern in insurance. We have some concern, however, that in the new regulatory environment, the potential failure of a large, complex financial group with both banking and insurance subsidiaries could tempt regulators to transfer assets from healthy insurance subsidiaries within the group to prevent the failure of a banking subsidiary. This is particularly the case given the Federal Reserve's historically bank-centric approach. Under current federal law, the Fed Board may not require an insurer affiliated with a bank in a bank holding company structure to transfer funds or assets to the bank if the state regulator for the insurer refuses to approve the transfer. As noted above, however, there currently are no insurers operating as part of a bank holding company structure, only insurers operating in savings and loan holding companies (SLHCs), and this existing federal law does not apply to SLHCs.

We believe **the United States has been wise to place policyholder protection as its primary solvency goal and should resist any effort to shift to an approach that could allow insurance subsidiaries to be used as a "source of strength."** The sole possible exception is for troubled SIFI insurers in the midst of a systemic crisis, although policymakers should keep in mind that systemic risk is much less of a concern for traditional insurance activities than it is for banking activities.

Participate Fully in Global Forums

There is more than one path to achieving policyholder protection. The U.S. insurance regulatory system does not need to become like the European system, or vice versa, as both—and other systems—have been shown to work. Within the parameters of policyholder protection, however, global coordination on insurance regulatory matters can also be beneficial. It makes it easier for one country's regulators to trust another country's, and for jurisdictions to share information on IAIGs operating in multiple countries. Coordination can make resolution simpler. And reduced regulatory complexity can lower costs for consumers. This makes U.S. participation on the FSB and the IAIS, as well as on supervisory colleges for IAIGs that do business in the United States, valuable. **U.S. regulators should fully engage with these global forums—and provide the resources necessary to do so—to the extent they are compatible with protecting U.S. policyholders.**

The U.S.-EU Covered Agreement

The covered agreement negotiated by the United States and EU is narrow in scope and targeted toward a few areas of disagreement between the two jurisdictions. The NAIC has argued that an agreement on reinsurance collateral is unnecessary because states are already on their way to addressing the issue, the agreement does not guarantee that the EU will grant the United States equivalence under Solvency II, and the agreement is ambiguous as to what would prompt action by regulators to enforce compliance.[108] Even if it is the expectation that all 56 NAIC states and jurisdictions will adopt the suggested reinsurance collateral changes, there seems to be no compelling reason not to use the covered agreement to make the change official. Overall, the covered agreement should help the United States make its case for equivalence under Solvency II. The Trump administration has an opportunity to review these judgments with insurers, state regulators, and their European counterparts. Assuming they agree, we expect that they will move forward with the covered agreement at the appropriate time in the process.

Do Not Adopt Mark-to-Market Accounting Standards

In recent decades, there has been a move by regulators to enhance transparency of asset prices by requiring them to be "marked to market," or valued on a regular basis to actual market prices. Such a requirement gives a more accurate and up-to-date picture of a firm's financial health in the moment, which can help to prevent creative bookkeeping that does not reflect a financial institution's true health, and provides an early warning sign that falling asset prices are a sign of danger for a firm. Mark-to-market accounting can also promote market discipline because a financial firm knows that it may be punished by investors or have corrective action taken against it by regulators if the quality of its balance sheet slips.

While mark-to-market accounting provides benefits, including market discipline, it also creates systemic risk because it can exacerbate fire-sale dynamics. A financial stress event often starts because of a sudden drop in prices for one or more classes of assets. Financial firms that hold these assets see their balance sheets suffer just as suddenly, and can be forced to sell assets to improve their capital positions. These forced sales further depress asset prices, forcing yet more downward pressure on prices in a negative feedback loop. The financial firms that failed or almost failed in the last crisis were victims of this fire-sale dynamic and high levels of leverage, which did not allow them to take on significant losses before becoming insolvent.

In the United States, insurers have used historic cost accounting—which bases the value of assets on their purchase prices—for their insurance liabilities. As we explained earlier, a core competency of life insurers is to match the terms of their liabilities with their assets.

Applying mark-to-market rules to insurers is more problematic than it is for banks. Because most policies pay out only when an insurable event occurs, insurers are not susceptible to run risk in the way banks or other financial firms that rely on short-term wholesale funding are. For this reason, the market price of an asset is less relevant than whether or not it is in default. But subjecting insurers to mark-to-market rules would make them vulnerable to fire-sale dynamics if they were forced to sell off performing assets, thus increasing systemic risk.

U.S. regulators should be aware of current data, including pricing, on insurance company assets to better inform decision-making. And to the extent accounting standards can be better harmonized globally without causing significant problems, the United States should seek to do so. **However, we recommend U.S. policymakers continue to avoid the adoption of mark-to-market accounting rules for insurance assets in any way that could reasonably be expected to trigger or fuel fire-sale dynamics.**

Include FSOC's Independent Member in "Team USA"

Earlier in this report, we recommended that Congress combine the positions of FIO director and FSOC independent member. While this is the best policy option for a number of reasons, Congress may decide not to take this action for some time.

To the extent that the two positions remain separate, FSOC's independent member will retain the responsibility to vote on whether to designate or de-designate insurers as SIFIs. The global debate on G-SIIs and whether to designate them should not be the deciding factor in whether FSOC decides to designate a firm as a SIFI, but it is relevant. Therefore, **the independent member should be included on "Team USA" and consulted by its other members on all issues in which systemic risk overlaps with insurance.** In addition, **the independent member should be fully informed on global debates on insurance oversight related to systemic risk and have the opportunity to offer their opinion on such issues in global forums.**

Conduct Study of Impact of G-SII Designations

The FSB and the IAIS should be directed to conduct a study of the impact of G-SII designations on insurance markets and policyholders. The study should also include an assessment of the costs and benefits of a shift to an approach to IAIGs that focuses on risky activities and products rather than the designation of individual firms.

Conclusion

Insurance plays a critical role in the U.S. economy, helping individual consumers and businesses of all sizes to reduce and better manage their exposures to potential risks to their lives, property, and enterprises. Consequently, the effective and efficient regulation of the business of insurance is important for consumers, the larger U.S. financial system, and our domestic economy.

The start of a new administration and a new Congress offers an opportunity to pause and assess the current state of that regulation. This is especially true in the United States, where the legacy state-based regulatory system continues to evolve in the face of a dynamic and competitive marketplace, increased federal oversight and intervention, and new international standards designed to mitigate systemic risk in the wake of the 2007-8 global financial crisis. These regulatory interconnections at the state, national, and global levels are complex and deserve a fresh look from all stakeholders, especially policymakers.

This report is BPC's contribution to start a much-needed public policy debate on improving insurance regulation and supervision. Over the course of two years, BPC has developed a series of recommendations designed to address issues identified to improve existing state-based regulation, federal oversight, and international standards. If the new administration and Congress decide to expand the federal role in insurance regulation in the future, we offer a set of forward-looking recommendations to consider at that time. Finally, while our work is grounded in achieving better outcomes for all consumers and the economy, we also make several recommendations specifically tailored to better meet the needs of consumers going forward.

Appendix A: The Task Force and the Process for Writing the Report

The Insurance Task Force

The co-chairs of the Insurance Task Force are:

- **Robert E. Litan**, Adjunct Senior Fellow, Council on Foreign Relations; and
- **William H. McCartney**, Former President of the NAIC and Nebraska Director of Insurance

Special thanks to those connected with BPC's Financial Regulatory Reform Initiative who helped inform and guide us through this process, including: Co-Chairs **Martin Baily** and **Phillip Swagel**; BPC staff **Justin Schardin**, **Ashmi Sheth**, and **Dora Engle**; and senior advisors **Jim Sivon**, partner with Barnett Sivon & Natter, PC, and **Greg Wilson** of Greg Wilson Consulting.

Background on the Process for Developing this Report

The authors developed their conclusions based on their extensive experience in insurance regulation, as well as information-gathering sessions with a wide variety of public- and private-sector experts, agencies, organizations, and individuals. The authors benefitted greatly from these meetings and are indebted to all who met with them. However, the authors alone are responsible for the conclusions and recommendations in this report.

Meeting Questionnaire

The authors used the following questionnaire to help structure their discussions with current and former regulators, consumer and industry representatives, and academics.

1. General questions

i. Is the amount of overall insurance regulation, in general, too little, too much, or about right?
ii. Are there any areas in which Americans are, in general, underinsured? To what extent are any such areas the result of regulation or laws?
iii. Did Dodd-Frank affect insurance more, less, or about as much as you expected? In what ways?
iv. Some have argued that one reason for the regulatory gaps that have appeared from time to time between insurance, banking, and securities products is the lack of an agreed-upon definition of insurance. Should such a definition that can be agreed upon by all relevant domestic jurisdictions be pursued? Why or why not?

2. Consumer issues

i. Are U.S. consumers well served by the current U.S. insurance regulatory structure? If so, how? If not, why not?
ii. How does the current regulatory system affect the ability of insurance companies to serve their customers efficiently and effectively?
iii. Does the current insurance regulatory system provide appropriate consumer protections? What protections are appropriate (for example, transparency, disclosure, rate regulation, limits, or other restrictions)?

3. Economic impact

i. What is the impact of the current regulatory regime on the domestic and global economies? How can those impacts be quantified? What trade-offs does the current regime make among economic growth, financial stability, and consumer protection? Are those trade-offs appropriate?
ii. Are insurance companies doing business in the United States, regardless of the country in which they are domiciled, able to meet consumer needs? Are they competitive in the national and international economy?

4. International issues

i. What are the strengths and weaknesses of the global system of insurance regulation? How could those weaknesses be improved?
ii. How can U.S. solvency regulation of insurers and their holding companies be better reconciled with that of the EU and other global jurisdictions?
iii. Who speaks for the United States in international insurance negotiations? Who should?
iv. Other countries complain that the fragmented U.S. structure means that a U.S. insurer can get a single license to operate, for example, throughout the EU, while an EU insurer needs to get licenses and deal with regulation in many states to operate nationally in the United States. Is this an advantage for the United States and should it be changed?
v. Should policymakers try to improve coordination of capital and/or accounting standards across jurisdictions? If so, how?
vi. Are there areas of significant duplication or gaps in the oversight of internationally active insurance groups? If so, how would you address these?

5. State issues

i. What is/will be the impact of the changing regulatory environment on state guaranty funds and their ability to resolve insurance failures? How would you rate the quality and stability of state guaranty funds? Are there ways they could be significantly improved?
ii. Is the current system of state-based insurer solvency regulation adequate? Is the system for protecting insurer solvency based on risk-based capital levels the best approach? (State regulators may take corrective action to conserve or improve a company's financial condition if an insurer approaches a baseline capital level, a partial analogue to prompt corrective action for banks.) Would using a simple leverage ratio be better than using risk-based capital? Would you suggest any other changes?
iii. Insurance solvency regulation has been moving toward more reliance on insurers' internal models and away from standardized formulas. Do you believe this move is appropriate?
iv. How would you assess the performance of the National Association of Insurance Commissioners (NAIC)? Would you suggest any changes to its structure, governance, policies, focus, or anything else?
v. Should the election and appointment structure for state insurance commissioners be changed to de-politicize them?

vi. Some states only allocate a small portion of the premium taxes they collect to these state insurance authorities. Further, some states have retaliated against other states that have lowered premium taxes to attract companies. Should the process for funding these authorities be changed?
vii. Is rate regulation still needed in a market economy or should it be eliminated in favor of full and fair disclosure similar to other financial products (for example, mortgages)?
viii. Should there be uniform coverage caps in all states to ensure that all claimants, regardless of the state in which they live, receive the same maximum benefits in the case of the failure of an insurer? If so, what should the cap be? Should it be indexed?
ix. What is the practical effect of the intersection between the Federal Reserve Board's authority over insurers and state insurance regulation and international insurance agreements?

6. Systemic risk and insurance

i. Is the business of insurance systemically important like banking or other areas of finance? If so, how? If not, why?
ii. Are individual insurance companies now, or could one or more become, systemically important? If so, how, and by what metrics or guidance can that systemic importance be judged? If not, why?
iii. How should the Financial Stability Oversight Council's (FSOC) non-bank designation process, established in the Dodd-Frank Act, apply to insurance companies? Should the designation process be clarified or altered? If so, how?
iv. Should FSOC's authorities be amended to give it additional tools beyond designation to address systemic risk that may result from the business of insurance or from individual insurance companies?
v. Is the business of reinsurance, or specific reinsurance companies, systemically risky? How should FSOC and other regulators address this part of the market?
vi. Dodd-Frank gave the Federal Reserve the authority to regulate insurer solvency for designated SIFIs and insurers that are organized as thrift holding companies. Has the impact of that change been positive, negative, or neutral?
vii. What is the optimal regulatory regime for prudential supervision that is tailored to the business of insurance (for example, as it applies to capital, liquidity, reserves, group supervision, etc.)? Does the Federal Reserve have the knowledge and expertise to effectively regulate SIFI insurance companies? If not, what should it do to reach that point?
viii. What is the competitive impact of designation on insurance companies?

7. Resolution of insurance companies

i. Dodd-Frank expanded the Federal Deposit Insurance Corporation (FDIC)'s resolution authority to include non-bank financial companies. Do you think this action is likely to be a positive, negative, or have not much effect on the ability to safely wind down covered insurance companies?
ii. Will the FDIC's single-point-of-entry system work for insurers? If not, could it be altered to work, or is a different approach necessary? If so, how would you go about calculating appropriate levels of capital and loss-absorbing capacity?
iii. Does the FDIC have the knowledge, expertise, and appropriate framework in place to effectively resolve insurance companies? To evaluate "living wills" for

such companies? To understand how they are different from banks? If not, what should it do to reach that point?

iv. Is there a need for a federal backstop for insurance failures, such as we have in the Deposit Insurance Fund for banks? Or, a different model?

v. Is global cooperation on the resolution of globally active insurers adequate to address a future failure? If not, what needs to change?

8. The future of the Federal Insurance Office (FIO) and the federal role in insurance

i. What is the appropriate role and function of FIO? Does it have too much, too little, or about the right amount of authority?

ii. Is FIO in the right place as an office within the Treasury Department? Should it have more or less independence than it has? (Examples: The Office of Financial Research does not have to clear its public comments with the Treasury Department, while FIO does. The Office of the Comptroller of the Currency is housed within the Treasury Department but operates as an independent agency.)

iii. Is there a need for a national insurance charter and/or a federal insurance regulatory agency, or are there mechanisms that would permit greater uniformity in state regulation, such as:

1. Covered agreements;
2. State compacts;
3. A passporting system;
4. Federal standards; or
5. A hybrid structure where states retain market conduct regulation and the federal government takes on solvency regulation?

Should FSOC-designated SIFI insurance companies operate under a new federal charter? What is the optimal regulatory structure for such designated firms?

In the case of a hybrid structure as described above, is there a danger of conflicts between state rate regulation and federal solvency regulation? If so, could that be mitigated by allowing federal pre-emption of state rates in cases where they jeopardize solvency? What about cases when the solvency of an insurance and thrift subsidiary in the same financial holding company are both at risk?

If a national charter is created, should it be optional for all companies or mandatory for some?

iv. Is regulatory arbitrage a concern under a federal charter? If so, how would you address it?

v. Should the CFPB have a role under a federal charter? Why or why not?

9. Natural catastrophe and cyber insurance

i. Should regulators allow insurers to set aside reserves for natural catastrophes? If not, why? If so, what rules should govern when and how those reserves could be used?

ii. How should regulators handle the rise of cyber attacks and the increasing need for insurance to cover them?

10. Is there anything we have not asked but should have?

Appendix B: Glossary of Acronyms

ACLI: American Council of Life Insurers

BPC: Bipartisan Policy Center

CDS: Credit default swaps

ComFrame: Common Framework for the Supervision of Internationally Active Insurance Groups

FCA: United Kingdom Financial Conduct Authority

FIO: Federal Insurance Office

FSB: Financial Stability Board

FSOC: Financial Stability Oversight Council

G-SIIs: Global Systemically Important Insurers

IAIGs: Internationally Active Insurance Groups

IAIS: International Association of Insurance Supervisors

ICPs: Insurance Core Principles

NAIC: National Association of Insurance Commissioners

NTNI: Non-traditional non-insurance

OCC: Office of the Comptroller of the Currency

OECD: Organization for Economic Co-operation and Development

OFC: Optional federal charter

OFR: Office of Financial Research

OTS: Office of Thrift Supervision

P/C: Property and casualty insurance

RBC: Risk-based capital

SEC: Securities and Exchange Commission

SIFI: Systemically important financial institution

SLHCs: Savings and loan holding company

SMI: NAIC's Solvency Modernization Initiative

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