Global Insurance Regulatory Issues:

Implications for U.S. Policy and Regulation

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About the Insurance Task Force

The Insurance Task Force is part of BPC's Financial Regulatory Reform Initiative, which was created to assess the Dodd-Frank Act and recommend practical policy solutions to improve it. The task force is co-chaired by Republican William H. McCartney, former president of the National Association of Insurance Commissioners and Nebraska state insurance director, and Democrat Robert E. Litan, longtime regulatory policy scholar and former Clinton administration official. Through stakeholder engagement and in-depth analysis, the task force is examining the changing structure of insurance regulation as a result of Dodd-Frank, both within the United States and internationally, and recommending policy reforms that promote effective and efficient regulation for the 21st century. The task force plans to release a series of mini-papers on current topics in insurance regulation, along with a final report of recommendations in 2016.

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Introduction

The far-reaching impacts of the global financial crisis of 2007-2008 triggered a robust debate about the proper structure and practices of financial regulation. Although the business of insurance was not at the heart of the crisis, the near-collapse of one major global insurer, American International Group, Inc. (AIG), led international policymakers to take a closer look at insurance regulation and coordination at the international level.

In the United States, the Dodd-Frank Act established a new federal role for insurance regulation for the Federal Reserve Board and created the Federal Insurance Office (FIO). The G-20 countries created and augmented international forums to coordinate their efforts on cross-border insurance matters.

A number of pressing matters now face policymakers. Global regulators are developing a global standard for insurance capital, and also standards for coordinating their supervision and regulation of large, globally active insurers. The European Union (EU) is set to implement a new, comprehensive insurance regulatory regime with significant implications for U.S.-based companies, and the United States and EU are working toward an agreement on insurance oversight that could involve real concessions on both sides.

This paper summarizes the key participants in global insurance regulatory debates and the main issues with which they are wrestling. It includes several initial observations and recommendations:

1) Global coordination on insurance regulatory issues is a positive dynamic, but policyholder protection should remain the top priority of regulators.

2) The "Team USA" approach to international insurance negotiations is a step forward but is not sustainable in the long run. Its structure should be changed to clarify who speaks for the United States on global insurance matters and how the different U.S. participants should achieve consensus views to represent to other countries.

3) Resolving large, complex insurers that fail is very different from resolving large, complex banks. U.S. regulators should make it a priority to understand these differences and detail how they will approach the resolution of insurers.

This paper is laid out in three sections. The first section gives a **background** of some of the major world, U.S., and EU actors in global insurance negotiations and their main efforts since the financial crisis. The second section summarizes **key issues** these actors and other policymakers are trying to hash out and what they mean. Finally, the third section presents several **recommendations** from the Bipartisan Policy Center's Insurance Task Force.

The paper precedes a final report, which will include recommendations to improve insurance regulatory reform at the global, national, and state levels, to be issued in 2016.

Background

Insurance as a Global Business

The business of insurance has become more globalized, with more large insurers doing business in numerous countries and with the overall market for insurance expanding as output and incomes have grown. Between 2008 and 2013, much of the growth in global insurance activity occurred in developing markets. China's share of global premiums grew by more than 80 percent, Brazil's by more than 70 percent, and South Korea's by almost 40 percent.[1]

The growth in the demand for insurance has been accompanied by the growth in the number and size of globally active insurers. Multiple factors have driven the globalization of the insurance business, including greater demand for insurance products especially in emerging markets, technological innovations that made it easier to design and sell insurance policies in multiple countries, and a general move toward market liberalization.

The trend toward globalization in insurance is not surprising given similar trends in banking and other areas of commerce. However, the business of insurance has unique elements and differs from banking and general commerce. For example, insurance companies generally operate through separately capitalized subsidiaries in each country in which they do business, in contrast to many businesses that operate through integrated multinational corporations.

Not surprisingly, the world's regulators have taken notice of developments in insurance markets, particularly following the global financial crisis. The crisis-era experience with AIG, for

example, showed that non-insurance activities undertaken by an insurance company, coupled with securities lending by the insurance entity itself, can threaten financial stability and that subsidiaries in other countries can impact the U.S. financial system.[2] Regulators have responded by taking additional steps to better coordinate their oversight of insurers that do business across borders, including working to develop a regime of capital, supervisory, and other requirements for the largest, most complex globally active insurers. The Financial Stability Board (FSB) has designated nine large insurers as global systemically important insurers (G-SIIs—see Appendix A) three of which are headquartered in the United States. The International Association of Insurance Supervisors (IAIS) has estimated there are now about 50 internationally active insurance groups (IAIGs)—including the nine G-SIIs—that will be subject to additional oversight.

Insurance regulators also have placed an increased emphasis on supervision of insurance groups, which are defined by the IAIS as groups of companies that include at least one insurer and at least one other company that "has significant influence on the insurer."[3] Regulators want insight into the activities of insurance groups as a whole and are improving their coordination to address any issues that may arise from their observations. This is particularly important as regulators from multiple jurisdictions use group supervision of IAIGs to improve coordination, communication, and data-sharing.

In sum, globalization and the financial crisis triggered a reevaluation of insurance regulation in the United States and around the world, leading to the empowerment of international bodies to address global insurance regulatory issues, and a new role in insurance regulation for the U.S. federal government. Several years after the creation of the FSB and the passage of the Dodd-Frank Act in the United States, it is time to review and better understand the new global insurance regulatory framework.

Global Insurance Regulators and Forums

The Financial Stability Board and the International Association of Insurance Supervisors

In 2009, the G-20 countries established the 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. Its membership includes representatives from 23 countries, Hong Kong, and the EU; four international financial institutions; and six international bodies.[4] The United States is represented by the Department of the Treasury, the Federal Reserve Board of Governors, and the Securities and Exchange Commission.

One of those 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.[5] The IAIS includes an executive committee that makes decisions necessary to achieve the objectives laid out by its membership.

National regulators and supervisors are not legally bound by FSB or IAIS rules, which instead must be implemented through regulation or legislation by authorities within each country. However, the FSB and IAIS are involved in several issues that will significantly impact global insurance oversight and, in some cases, have already done so.

Recently, the FSB and the IAIS have undertaken several initiatives to enhance regulatory standards and improved coordination among regulatory bodies. These include efforts to create a global framework for the oversight of IAIGs and G-SIIs, and to establish a global insurance capital standard. In April 2015, for example, FSB Chairman Mark Carney informed the G-20 finance ministers and central bank governors that the IAIS would finalize higher

loss-absorbency requirements for G-SIIs by November.[6] The IAIS did so in September.

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.[7] As part of its Financial Sector Assessment Program, the International Monetary Fund (IMF) and the World Bank conduct periodic reviews of individual countries' observance of ICPs and issue assessments of a country's insurance supervisory regime.[8]

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,"[9] 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.[10]

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.

Globally Significantly Important Insurers

Following the financial 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."[11] 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.[12] These extra standards, however, must be imposed by a company's home country.

In July 2013, the IAIS published its initial methodology for designating G-SIIs.[13] The methodology, which is similar to the one used by the Basel Committee to designate global systemically important banks, assesses systemic risk in five categories: size, global activity, interconnectedness, non-traditional and non-insurance (NTNI) activities, and substitutability. An insurer being reviewed is assigned a "designation score" based on multiple weighted indicators within each category. The interconnectedness and NTNI activities 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.

The FSB released its initial list of G-SIIs immediately after the IAIS published its initial methodology. The list included nine insurers, including three based in the United States: AIG, MetLife, Inc., and Prudential Financial, Inc. The FSB updates its G-SII methodology annually. In November 2015, the FSB removed one company (Assicurazioni Generali) from the list of G-SIIs and added another company (Aegon) to the list."[14]

So far, the IAIS has not published a methodology to assess the systemic importance of reinsurance companies, none of which

have been designated as G-SIIs to date. The IAIS is scheduled to update its methodology to include reinsurance by November 2015, which is a deadline that had been delayed by a year in November 2014.[15] It is not clear yet whether any reinsurance companies will be recommended by the IAIS for designation, nor whether the FSB will act on those recommendations.

The European Union and Solvency II

On January 1, 2016, the EU will implement Solvency II, a risk-based insurance regulatory and capital regime that is similar in structure to the Basel regime for banks. Solvency II was created to develop a single EU insurance market and harmonize insurance regulation across member countries (i.e., by allowing EU companies to operate in all EU countries with a single license), improve consumer protection, modernize supervision, and make EU insurers more internationally competitive.

Solvency II consists of three main groups of requirements:

1) **Quantitative and financial:** These include risk-based capital requirements for insurers and a common methodology for valuing insurance assets and liabilities; valuations can be made either using companies' internal models, subject to supervisory approval, or a standard formula.

2) **Governance and Supervision:** These include standards for risk management and governance, a requirement for companies to assess their own risks and future capital requirements, and standards for supervisors to review companies and intervene in case of problems.

3) **Reporting and Disclosure:** These include measures to enhance transparency with the public and with regulators, with a goal of helping impose more effective market discipline on the insurance industry.

Non-EU countries are adjusting to the imposition of Solvency II, importantly by asking the EU to classify their own insurance regulatory regimes as "equivalent" to Solvency II in criteria such as providing adequate policyholder and beneficiary protection and imposing appropriate capital requirements on insurers. Equivalence means that a non-EU insurer could operate in the EU without complying with all of the EU's rules and that an EU insurer could operate in a non-EU country under that country's local rules.

The U.S. system differs with Solvency II in a number of ways, including how assets and liabilities are valued, which kinds of risk are evaluated, and whether off-balance-sheet assets and liabilities are taken into account in assessing the financial position of insurers. It is not clear yet whether the United States will be granted full equivalency by the EU under Solvency II. Equivalency for the United States is discussed below in further detail.

The Players at Home: U.S. Participants in Global Insurance Forums

The National Association of Insurance Commissioners (NAIC)

The NAIC is an organization of the chief insurance regulators from each of the 50 U.S. states, the District of Columbia, and five U.S. territories. It is primarily focused on standard-setting and providing support to its members. The NAIC's activities include setting standards for financial reporting by insurers, developing model laws and regulations, collecting and disseminating data about the insurance industry, and establishing standards and best practices for state regulators, which are the NAIC's members. The NAIC itself does not have regulatory authority or the power to enforce its standards on its members.

Since its members have supervisory and regulatory authority over the U.S. insurance industry, the NAIC participates in some, but not all, international insurance regulatory forums. The NAIC is the primary U.S. member of the IAIS; however, the NAIC and its member state regulators are not represented on the FSB. Thus,

the NAIC has a voice in developing the assessment methodology for identifying G-SIIs but no voice in designating them. This is somewhat analogous to the U.S. financial regulatory system in which a state regulator serves as a non-voting member of the Financial Stability Oversight Council (FSOC). FSOC designates U.S. systemically important financial institutions (SIFIs); and while the NAIC has a voice in the designation process for insurers, it has no vote.

The Federal Reserve

Historically, NAIC members had sole jurisdiction for the regulation and supervision of almost the entire U.S. insurance industry.[a] This reflects a policy of federal deference to the states that is embodied in the McCarran-Ferguson Act. That Act reserves the regulation of the business of insurance to the states, unless the federal government expressly exercises authority over a particular product or market activity, which it has done in some instances such as health insurance, flood insurance, terrorism insurance, and crop insurance. Under the Dodd-Frank Act, however, the Federal Reserve Board now has supervisory authority over about one-third of the industry, as measured by assets,[16] alongside the pre-existing authority of state supervisors.

The Federal Reserve Board oversees two kinds of insurers:

1) Those that have been designated by FSOC as SIFIs.

2) Those organized as savings and loan (or "thrift") holding companies (SLHCs) or bank holding companies (BHCs). There are 14 such companies organized as SLHCs, including some large, complex insurers. No insurer currently is organized as a BHC.

It is not clear how the Federal Reserve will use its new authority to regulate insurance companies, or whether or how it will treat SIFIs and insurers organized as SLHCs differently. Representatives of the Federal Reserve have indicated they intend to focus on group supervision and financial stability,[17] not on duplicating state oversight. Perhaps the most important insurance-related decision the Federal Reserve Board will make is what capital requirements it will impose on the insurers under its supervision. Historically, the Federal Reserve has been a bank and bank/financial holding company supervisor and regulator, and it has not had to apply capital regulation to nonbanks. How well the Federal Reserve tailors its oversight of nonbanks such as insurers in order to address their unique risks, balance sheets, revenue streams, and business models will determine how successful the agency is in its new role as an insurance regulator.

The Federal Reserve Board has been a member of the FSB since it was created in 2009. The Board applied for membership to the IAIS in 2013 soon after FSOC had designated its first insurer SIFI and was granted full membership in 2014.[18]

The Federal Insurance Office (FIO)

Dodd-Frank established FIO as a new office housed within the Treasury Department. FIO was created, in part, because the financial crisis demonstrated the federal government's lack of knowledge and understanding of the insurance industry.[19] Congress did not give FIO the same level of independence it has extended to the Office of the Comptroller of the Currency (OCC), which is a bureau of the Treasury Department with significant autonomy. For example, the Treasury secretary appoints the head of FIO, which is part of Treasury's Office of Domestic Finance, while the head of the OCC is a presidential appointee. Also, FIO specifically was not given domestic regulatory authority. Instead, FIO is charged with functions such as monitoring and collecting data about the insurance industry and recommending to FSOC whether it should designate one or more insurers as SIFIs.[20] FIO's director is a non-voting member of FSOC.

In addition, FIO has the responsibility "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate in the [IAIS] and assisting the [Treasury]

[a] The federal government has had a presence in insurance market segments such as terrorism risk insurance and flood insurance. In addition, the Securities and Exchange Commission regulates certain kinds of annuity products that are structured as securities.

Secretary in negotiating covered agreements."[21] The prospect of a covered agreement—namely, an agreement between the United States and one or more other foreign countries regarding recognition of regulatory measures relating to insurance—with the EU in particular is controversial, as this paper discusses later in more detail.

The U.S. Treasury Department

Although the Treasury Department does not regulate insurance, it is a member of the FSB and the Treasury secretary chairs FSOC, which has the authority to designate insurers for enhanced supervision by the Federal Reserve Board. In addition, Treasury is indirectly represented on the IAIS and the IAIS executive committee since FIO, which is a member of both, is part of the department.

FSOC Independent Member with Insurance Expertise

As part of the Dodd-Frank Act, 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 would have effectively given Treasury two votes, Congress created a position for an "independent member … having insurance expertise" as a voting member of FSOC.[22]

The independent member with insurance expertise has no formal role in global insurance discussions or negotiations. In February 2014, the current independent member, Roy Woodall, was approved for observer status on the IAIS, which allowed him access to non-public materials and the ability to comment on the body's work.[23] However, the IAIS voted later that year to end observer status for all non-members.[24] Since observers were primarily members of the insurance industry who paid dues to the IAIS, some argued that observers harmed the credibility of the body by giving the appearance that industry was receiving something in exchange for their contributions to its operating budget.[25] Nevertheless, a decision that was aimed at eliminating possible undue industry influence in IAIS decision-making resulted in FSOC's member with insurance expertise no longer being able to participate or observe the global body tasked with determining a framework for designating systemically important insurance companies.

Key Issues

Who speaks for the United States in International Insurance Arenas?

The U.S. financial regulatory system has long been fragmented and is among the most complex national regulatory systems in the G-20. It has a dual federal-state system of banking regulation, separate regulators in each state, and multiple overlapping federal prudential banking and capital-markets regulators. Historically, the U.S. insurance system has been primarily state-based, but with the advent of a federal role for insurance oversight and other national laws (e.g., flood insurance, terrorism insurance), the U.S. insurance regulatory system also has become more complex with a greater federal role.

In discussions with a cross-section of insurance experts and stakeholders, the task force has heard multiple different answers to the question of who speaks for the United States in global insurance negotiations and even more different answers to the question of who should. Here are the existing U.S. players' roles and limitations; Table 1 summarizes their key activities and limitations.

FIO was explicitly given the authority in Dodd-Frank to represent the United States 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 speak for all of its members nor to compel its members to adopt its policies or model legislation

Table 1: 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[b]	No
IAIS member?	Yes	Yes	No	Yes	No
IAIS Executive Committee member?	Yes	No	No	Yes	No
FSOC member?	Non-voting[c]	Voting	Voting Chairman	Non-voting	Voting

[b]Although FIO is not a member of the FSB, it is part of the U.S. Treasury Department, which is a member.

[c]Although the NAIC is not a member of FSOC, the Council includes a non-voting member who is a state insurance commissioner.

and regulations. State regulators also have historically focused on oversight of insurance companies and their activities only in their states and not on 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 regulators and now has regulatory authority over several of the largest, most complex U.S.-based insurers. However, the 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 Federal Reserve 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 may be challenging, particularly while the 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 Federal Reserve Board, and the NAIC all sit on the IAIS, which develops the methodology to assess G-SIIs. The Federal Reserve Board and 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.

The various U.S. insurance authorities have touted a "Team USA" approach, which aims to find common positions on most global insurance regulatory issues.[26] This approach is a positive step, but its applicability and accountability have not yet been seriously tested.

Some believe the current system is workable, while others believe change is needed. The task force falls into the latter camp. Dodd-Frank has further fragmented and realigned responsibilities and authorities. With the benefit of five years of experience, it is becoming increasingly apparent that policymakers could clarify and improve the situation.

On the question of who should represent the United States, there are a number of options:

- Rely on one of the existing U.S. participants to take the lead: the NAIC as the primary regulator of U.S. insurers, the Federal Reserve as the consolidated regulator of most U.S.-based IAIGs, or FIO as intended in Dodd-Frank.
- Use the "Team USA" approach of arriving at group consensus among U.S. participants, possibly including a codification of that relationship among those participants by Congress.
- Create a new national insurance charter and federal insurance regulatory agency, the head of which would represent the United States; this could be either mandatory, such as for designated G-SIIs IAIGs, or other insurance companies regulated by the Federal Reserve, or it could be optional for any company wanting a national charter as a platform for serving insurance consumers at home and to have a single regulator to set a framework abroad.
- Accept the fragmentation of the U.S. financial regulatory system and rely on different participants or combinations of participants to represent the United States in different situations or bodies (e.g., the Federal Reserve and Treasury Department on the FSB, and the NAIC, FIO, and the Federal Reserve on the IAIS).

Absent a more substantial structural change to the U.S. system of insurance regulation, the task force supports a strengthened "Team USA" approach, with details outlined in a concluding section on Recommendations.

Equivalence Under Solvency II

As part of the process for implementing Solvency II, EU officials will have to 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 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.
- **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.[27] This provisional equivalence is indefinitely renewable by the EU.

The EU can grant temporary equivalence in group supervision and reinsurance for up to five years. If granted, this temporary equivalence would not be renewable. If the United States is granted equivalence in group supervision, it would mean that U.S.-based insurers operating in the EU would be exempt from some of the EU's group supervisory requirements and may avoid having to make structural and operational changes. For example, U.S.-based companies could be required to fund higher levels of capital in their EU subsidiaries than otherwise, making

them less competitive.

A 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.[28]

Both U.S. and EU officials have expressed interest in negotiating covered agreements. The EU-U.S. Insurance Project's latest "Way Forward" document included support for a covered agreement on state-based reinsurance collateral requirements and group supervision, while also mentioning the confidentiality and exchange of supervisory information.[29 30] In April 2015, the EU Council of Ministers authorized the European Commission to negotiate a covered agreement with the United States.[31] U.S. officials have not yet authorized FIO and the U.S. Trade Representative (USTR) to open negotiations. In September 2015, however, FIO's annual report stated that the office expected to give notice to Congress that it intends to open negotiations "in the coming weeks."[32] The USTR has historically not played a major role in international financial regulatory agreements (e.g., Basel, FSB) but was given a statutory role under Dodd-Frank as part of covered agreements. This further complicates the question of who speaks for the United States in international insurance regulation.

Some U.S. policymakers are worried that international regulators are driving U.S. insurance regulatory decisions without sufficient input from state insurance regulators. Legislation has been introduced to address these concerns, including the International Insurance Capital Standards Accountability Act (S. 1086) introduced by Sens. Dean Heller (R-NV) and Jon Tester (D-MT) in April 2015.[33] Among other provisions, the bill would:

- Mandate that the Federal Reserve, the Treasury Department, and FIO achieve consensus with state insurance regulators through the NAIC whenever those agencies take or intend to take a position on an insurance proposal in an international forum.
- Require the Federal Reserve, the Treasury Department, and FIO to support increased transparency at the IAIS and other international standard-setting regulatory or supervisory forums on which they sit, including supporting observer access at the IAIS.
- Require congressional testimony and an annual report from the Federal Reserve and the Treasury Department on insurance regulatory or supervisory issues being discussed in international forums, positions these agencies have taken on them, steps being taken to improve the public transparency of discussions on these issues, and the likely impacts of proposals on U.S. consumers and markets.

The Financial Regulatory Improvement Act of 2015, sponsored by Sen. Richard Shelby (R-AL) and approved earlier this year by the Senate Banking Committee on a party-line vote, includes a modified version of the Heller-Tester bill.[34]

U.S. regulators have acknowledged that standards issued by the FSB or the IAIS will not be binding on U.S. insurers and can only be implemented by federal or state authorities in the United States.[35] Also, as noted earlier, U.S. regulators emphasize the "Team USA" approach to global negotiations that seeks to establish consensus between federal and state regulators where possible. However, it is unclear what would happen if members of "Team USA" are not able to reach consensus, or if the U.S. federal or some state governments would refuse to pass authorizing legislation to implement international agreements.

Reinsurance Collateral

One of the covered agreements the EU would like to negotiate with the United States would address reinsurance collateral. The EU reportedly wants to remove state-level collateral requirements for EU reinsurers. 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.[d] 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 and others have argued that collateral requirements exist to ensure assets are available domestically to promptly pay claims to U.S. policyholders and protect the solvency of U.S.-based insurers that buy reinsurance. The NAIC has further said that a covered agreement is unnecessary given progress states have made in reducing the burden on foreign reinsurers.[36] In 2011, the NAIC passed significant changes to its Credit for Reinsurance Model Law and Regulation, which would reduce collateral requirements for qualified reinsurers that meet certain criteria. The NAIC reports that as of March 1, 2015, 25 states representing 60 percent of direct U.S. premiums have passed a version of the model law, with another 12 states intending to do so within 12 months.[37]

In its 2013 report on modernizing the U.S. insurance regulatory system, FIO noted progress from states but argued it was incomplete. FIO reported that state-by-state determinations of whether a foreign reinsurer is qualified lack uniformity and that determinations of a reinsurer's creditworthiness rely too much on credit-rating agencies rather than risk-based empirical factors. Also, FIO noted that collateral relief should be provided based on sound credit risk-management practices.[38]

FIO's report implies that the Office believes that non-U.S.-based reinsurers would still be treated less favorably than U.S.-based reinsurers even if all states adopted the NAIC's model action and regulation. This makes reinsurance collateral a potential target for a covered agreement and federal preemption of state measures that address the subject.

d 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.

Group Supervision

U.S. negotiators want the EU to grant equivalence to the U.S. insurance oversight regime in reinsurance and in group supervision, which has also been an issue for EU authorities. Foreign regulators have been concerned that while states have a good record of protecting policyholders and ensuring the solvency of insurance subsidiaries in their own states, those states lack the authority to monitor the activities of the full insurance groups and the risks they might pose to broader financial stability.

In 2008, the NAIC began its Solvency Modernization Initiative (SMI) to address group capitalization and supervision, among other issues, and adopted its SMI white paper in 2013.[39] The NAIC has adopted model legislation to improve group supervision, including changes to Insurance Holding Company System Model Act, which would give state regulators enhanced authority to supervise insurance groups. The NAIC also has argued that its "windows and walls" approach can effectively give regulators "windows" to look at group activity and the ability to "wall" off insurance capital from the rest of any non-insurance activities of a group.[40]

In 2014, the state of New Jersey went further, passing legislation that authorizes the New Jersey Commissioner of Banking and Insurance to be the group-wide supervisor for IAIGs headquartered in that state.[41] It 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 in their states.

The IMF'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.[42]

In its December 2014 designation of MetLife as a SIFI, FSOC noted that the company "is currently not subject to consolidated supervision," and that state insurance regulators lack the

authority to require insurance holding companies or other subsidiaries of holding companies to take or not take actions to preserve the safety and soundness of insurers or to avoid risks that would threaten U.S. financial stability.[43] Further, FSOC said that state regulators' authorities "have never been tested by the material financial distress of an insurance company of the size, scope, and complexity of MetLife's insurance subsidiaries."[44] FSOC's arguments, perhaps inadvertently, undermine the NAIC's case that its "windows and walls" approach is sufficient.[45]

The Federal Reserve Board stated that its role is complementary to, not duplicative of, state oversight. The agency has said it will focus on group supervision and financial stability rather than on the kind of supervision and regulation of individual insurers that states have been handling for decades. Indeed, the Federal Reserve's roughly 90 full-time equivalent employees who work to one degree or another on insurance could not duplicate the supervisory and regulatory activities of more than 12,000 employees of state insurance departments and the NAIC.[46] [47]

Taken together, FSOC's public statements on insurer designations and the Federal Reserve Board's statements on its supervision of designated insurers have been read by some to mean that these bodies view the states as either unable or ill-suited to deal with supervision of insurance groups and the risks they might pose to U.S. financial stability and that the Federal Reserve can and will fill these gaps. Since foreign regulators generally view the Federal Reserve's increased role in group supervision as a positive—the IMF's 2015 assessment said that the Fed's new group supervisory role "has strengthened supervision"[48]—this amounts to an argument for U.S. equivalence on group supervision at least for those companies that are under Federal Reserve oversight.

EU officials will need to determine whether progress by the states so far and the presence of the Federal Reserve as a group supervisor for most U.S.-based IAIGs will be enough to grant equivalence to the United States on group supervision in general. Negotiations on a covered agreement will likely be informed in part by the case FSOC has in effect made against the ability of states to engage in adequate group supervision.

The task force's research has shown broad support for and optimism about the ability of effective group supervision to improve the oversight of the insurance sector. To the extent that the state regulators are able to demonstrate success in their efforts to supervise insurance groups, it may ameliorate some of FSOC's concerns regarding the adequacy of state-based insurance regulation. As progress is made in overseeing large insurance groups, it may be helpful for FSOC, the FSB, and the IAIS to rethink their existing G-SII designations and designation framework.

Insurance Capital Requirements

In June 2014, the IAIS released its public-consultation document for basic capital requirements (BCR) that would apply a baseline level of capital requirements for G-SIIs. In December 2014, the IAIS followed up with a proposal for an Insurance Capital Standard (ICS) that would eventually take the place of BCR and apply to both IAIGs and G-SIIs under ComFrame.[49] The purpose of the ICS is to establish minimum levels of capital for globally active insurers to ensure they can absorb substantial, unexpected losses, still pay policyholders, and not threaten the stability of the financial system by their failure. The ICS would set minimum capital standards that supervisors in individual jurisdictions could exceed.

G-SIIs also would be subject to additional Higher Loss Absorbency (HLA) standards on top of BCR, much as systemically important banks are subject to additional capital requirements under Basel III. In October 2015, the IAIS publicly released its proposed capital requirements for G-SIIs.[50] Under the proposal, on average HLA would add an extra 10 percent to the BCR for each G-SII,[51] but the exact HLA level would differ for each G-SII depending on its risk profile and activities, particularly the presence of non-traditional insurance and non-insurance activities. The FSB endorsed the IAIS plan in September 2015 and the G-20 is expected to do the same in November 2015.

The ICS and HLA would apply on a consolidated basis to insurance groups rather than to individual subsidiary insurers within groups, and include non-insurance subsidiaries. The IAIS intends to finalize the ICS by 2016 and fully adopt it by the end of 2018.[52]

The IAIS document on the ICS focuses on three main issues that have yet to be resolved:

Valuation

The IAIS intends for the ICS to use metrics that are comparable across global jurisdictions. In order to achieve this goal, the IAIS argues that assets and liabilities need to be valued using the same accounting standards.[53] The document lays out three options for valuing assets and liabilities:

1) Use the accounting rules of each insurer's home country.
2) Use the accounting rules of each insurer's home country and then adjust them so they reflect current market value.
3) Use insurers' internal economic models.

The document chooses the second option as its default approach.[54] This approach is controversial since the United States uses different accounting standards than much of the rest of the world.

Many countries use the International Financial Reporting Standards method of accounting, which relies on market-based (or "fair value") pricing. Proponents of market-based pricing argue it gives a more transparent and accurate view of a financial institution's balance sheet. One danger, however, of relying on current pricing is that asset prices can experience large and rapid drops. When this happens, financial companies can be forced to sell assets to improve their capital ratios. If many companies are forced to sell at once, it creates a fire-sale effect that further depresses prices in a negative feedback loop. This dynamic was a major factor in propagating systemic risk during the most recent financial crisis.

By contrast, in the United States, both generally accepted accounting principles (GAAP) and insurer statutory accounting standards are more flexible in allowing non-equity assets to be valued at cost, provided the assets are still performing. Insurers are not required to mark down a debt instrument that they are holding for investment purposes and not intending to sell so long as the issuer of the instrument is current on debt service payments and is not otherwise in default. This practice counteracts damaging fire-sale dynamics.

Solvency II includes a "matching adjustment" to allow insurers to reduce the impact of price swings on the value of certain illiquid, long-term assets they hold.[55] The matching adjustment is intended to offset the danger of fire-sale dynamics. The use of the matching adjustment requires supervisory approval and it remains to be seen how European regulators will use this tool.

Qualifying Assets and the Capital Requirement

Like the Basel bank capital standards, the ICS would be risk-based, taking into account different risks posed by assets, liabilities, non-insurance risks, and off-balance-sheet activities. Forms of capital resources deemed to be less risky would count fully toward the minimum standard while those deemed riskier would be counted at a discounted rate, with the discount proportional to the estimate of risk. The ICS may divide capital resources into two tiers, with the decision of which tier to place a resource depending on its subordination, availability, loss-absorbing capacity, permanence, and extent to which the capital instrument is free of mandatory payments or encumbrances.[56]

The IAIS consultative document on the ICS also asks a series of questions about how to measure risk and which risks should be covered. It lists four categories of risk that could be measured: insurance, market, credit, and operational. Others, such as group and liquidity risk, would not be covered by the ICS but instead would be addressed qualitatively elsewhere within ComFrame.[57]

Differing Approaches to Group Capital

Some U.S. policymakers are concerned that the ICS will embody an approach to group capital that is more like the EU approach than the U.S. system. BPC's Insurance Task Force Co-Chair Robert Litan has described U.S. solvency regulation as walling off insurer capital from other parts of an insurance group to ensure that each company that is part of an insurance group has sufficient resources to pay policyholders. In effect, each subsidiary is responsible for itself. He contrasts this with EU solvency regulation, which he suggests treats financial groups as a whole, leaving open the possibility that insurers (either as holding companies or as corporate sisters within an insurance group) will be required to act as a "source of strength" for other subsidiaries of an insurance group to protect financial stability at the expense of policyholders.[58]

It should be noted that the main objective of Solvency II is the protection of policyholders and beneficiaries,[59] and the regime includes capital requirements for both insurance groups and subsidiaries. It also would not allow regulators to compel the transfer capital of an insurance group from the parent to the subsidiaries or between the subsidiaries unless the capital of the group and each relevant individual insurer within the group exceeds the Solvency Capital Requirement (SCR), a risk-based threshold that sets capital requirements for insurers to meet their expected obligations to policyholders and beneficiaries over the next 12 months with a 99.5 percent confidence level.[60]

Admittedly, there is the potential for tension between maintaining capital levels at an insurance subsidiary when a transfer of capital from it to another entity within an insurance group may help stabilize the financial system. Such cases may be rare but in the abstract they raise the possibility of a conflict between protecting policyholders and protecting taxpayers who may suffer from financial instability. Litan argues that U.S. policymakers should retain the U.S. focus on policyholder protection. The only exception may be during a systemic crisis when forced transfers of capital within a group are appropriate. FSOC should be required to declare that a crisis exists and to justify such a declaration.

In November 2014, the NAIC released a concept paper on a risk-based capital standard for U.S.-based IAIGs.[61] The paper lays out two alternative approaches to handling group capital, both of which would retain the current U.S. system for valuing assets and liabilities:

1) **RBC Plus:** This approach would extend the current way risk-based capital (RBC) is handled for insurance subsidiaries to the insurance-group level. The NAIC acknowledges RBC Plus would need to take into account risks that are not reflected in the existing RBC methodology. This approach would be less difficult and costly to implement for U.S.-based insurers and U.S. regulators.

2) **Cash Flow:** This approach would rely on insurers' internal models of projections of cash flow from assets and liabilities over time. The models would need to be approved by regulators and would be tested under normal and stressed scenarios.

The paper indicates that the NAIC is collaborating with the Federal Reserve and FIO in these efforts.

Designation of G-SIIs

As previously mentioned, the FSB and the IAIS rely on individual countries to implement their rules and decisions. This includes the FSB's designation of G-SIIs, which is a subset of the list of global SIFIs (G-SIFIs) that the FSB designates. The list of U.S.-based G-SIFIs will not necessarily match the list of SIFIs designated by FSOC. In this case, however, the list of U.S.-based G-SIIs is the same as the insurers FSOC has designated as SIFIs. This has caused some U.S. policymakers and companies to question whether the FSB is unduly influencing U.S. regulators on these issues.

The bifurcation of global-level and national-level designations highlights the fragmentation of the U.S. insurance regulatory structure in another way. The Federal Reserve and FIO have an opportunity to shape the methodology for designating G-SIIs on

the IAIS, and the Federal Reserve influences G-SII designations on the FSB. However, FSOC's independent member with insurance expertise votes on whether to designate U.S.-based insurers as SIFIs while playing no role, even as an observer, on either international body.

Resolution of IAIGs

The financial crisis identified an unwillingness by regulators to allow large, complex financial institutions to fail if such a failure was perceived to be a fundamental threat to the financial system. Federal officials stepped in to provide $185 billion to bail out and effectively take over AIG through stock purchases to ensure that the company's failure would not cause massive collateral damage to the rest of the financial system. In the aftermath of the crisis, policymakers vowed to end taxpayer-funded bailouts of "too-big-to-fail" financial institutions.

In an effort to accomplish this goal, Congress gave U.S. regulators significant authority to resolve these institutions in an orderly manner in Dodd-Frank. The FDIC has built on that progress with its single-point-of-entry resolution strategy that holds promise for better coordination on failure resolution for companies active in multiple countries. The FDIC has made agreements with several other countries on single-point-of-entry and is pursuing others. The FDIC, however, has said little to date about how the agency would resolve large, complex insurers and how that resolution would be different from banks.

Insurance company failures are very different from banks. Banks are susceptible to "runs" in which groups of customers suddenly withdraw their funds at once. To avoid runs, the FDIC shuts down a typical bank after the close of business on a Friday night and reopens it the following Monday morning after being acquired by another bank or under a new company managed by the FDIC. For customers, the resolution is mostly a non-event, and the swift resolution process maintains the franchise value of the bank and the stability of the broader banking system.

In contrast, a complete wind-up of the affairs of an insurance company can take years or even decades, since many claims from policy obligations take that long to be triggered. In addition, state regulators are responsible for insurance company resolution. Dodd-Frank gives the FDIC new authority to potentially resolve SIFI insurers, but only if that insurer's state regulator fails to act on a determination that the insurer is in default or in danger of default, and its failure would threaten U.S. financial stability.[62]

Recommendations

Global insurance regulatory issues are complex and usually do not have easy answers. One of the strengths of the U.S. insurance industry is its diversity of business models. What structure may work well for a global life insurance company may not work well for a property and casualty insurance company operating only in a couple of states. BPC's Insurance Task Force is still carefully weighing the best responses to each issue and conducting additional research.

The task force does see the move toward international coordination on insurance regulatory issues, particularly since the financial crisis, as a positive development. Approached the right way, it can allow national regulators a more holistic view of IAIGs doing business in multiple countries, help identify and fill gaps in cross-border oversight, result in more and better information-sharing, and improve response times in a panic or crisis. Agreeing on a common set of principles and rules also can lower the costs of doing business for both consumers and insurers by eliminating unnecessary duplication and making processes more transparent and less confusing.

At the same time, "one size fits all" is not a sound approach to insurance regulation. Each country has different market and demographic conditions and different priorities for its financial oversight. Regulators and supervisors rightly tailor their oversight of companies based on their size, activities, and other factors.

The United States should continue to pursue more global insurance regulatory coordination with its G-20 and other partners. U.S. officials also can and should ensure that this coordination remains consistent with key U.S. goals.

The task force offers four clear recommendations to improve global insurance regulation:

1. Policyholder protection should remain the primary goal of the U.S. solvency system.

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 the task force believes it is much less of a concern in insurance. The task force has 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 Federal Reserve Board may not require an insurer affiliated with a bank in a BHC 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 BHC structure, only insurers operating as SHLCs, and this existing federal law does not apply to SHLCs.

The task force believes 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.

2. FSOC's independent member with insurance expertise should be part of "Team USA" and included where possible on global insurance forums.

FSOC's independent member with insurance expertise plays a significant role in designating U.S.-based insurers as SIFIs but has no role, even as an observer, in the global bodies that develop rules and criteria for IAIGs and G-SIIs. It makes little sense to exclude the independent member from these global discussions when they highlight issues that are substantially similar to the ones that affect decisions he or she must make on FSOC.

The independent member had observer status on the IAIS for a short time until that body did away with observer status altogether. A primary reason for the decision was understandable: most observers were industry representatives who contributed some funding, which could make it appear that industry had undue influence with the IAIS. However, FSOC's independent member is one of several former observers to whom that logic does not apply.

The independent member has expertise in the business of insurance and also authority in matters of systemic risk and insurance. 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 have the opportunity to be fully informed on global debates on insurance oversight related to systemic risk and to offer his or her opinion on such issues in global forums. To that end, the Treasury Department, FIO, the Federal Reserve, and the NAIC should support giving the independent member formal access to any IAIS and FSB materials, meetings, and discussions related to insurance and systemic risk.

The task force sees real benefits, and no downside, to implementing this recommendation. It can be implemented without legislation, but Congress should step in if progress is not made to do so.

3. "Team USA" should be clarified and codified.

The decision by the NAIC, the Federal Reserve, and FIO to enhance their collaboration on global insurance issues with a "Team USA" approach is a positive development. Within the context of the fragmented U.S. insurance regulatory system, it is generally helpful to present a united front in international negotiations.

The "Team USA" approach is necessary at least at this time because it is not clear who speaks for the United States on global insurance issues, nor is it clear who should do so. As previously mentioned, FIO is given specific authority to represent the United States on certain global insurance negotiations but has no regulatory authority. The Federal Reserve lacks historical knowledge and expertise in insurance oversight and is focused only on group supervision and systemic-risk matters for just 17 U.S.-based insurance groups.[a] Although the NAIC is an association of state officials that regulate the insurance industry, the NAIC itself lacks the authority to require state legislatures or insurance commissioners to adopt its model laws and rules. It is hard to imagine the "Team USA" structure being tenable in the long run, and possibly not in the short run either.

If policymakers cannot agree on an alternative structure that would clarify this matter, they should at least formalize the "Team USA" concept, including adding the independent member as recommended above. This should include creating a coordinating body to provide a forum for discussion and strategy development for the team. There is ample precedent for such a body, including FSOC and the Federal Financial Institutions Examinations Council. One of the members of "Team USA" would chair the coordinating body and have the ability to call meetings, set meeting agendas, and direct staff. The task force sees at least three possible chairs of this body:

- **The director of FIO** already has a mandate to negotiate covered agreements and represent the United States internationally. The director could take on an additional role of coordinating among "Team USA" members to arrive at consensus positions.
- Leadership could be **situational** depending on the issue. For example, it would make conceptual sense for the NAIC to take a leading role in areas of expertise for state insurance commissioners, including matters of legal-entity supervision and resolution, insurance-market regulation, and solvency. Similarly, the Federal Reserve would take a leading role on group-supervision and financial-stability matters.
- The chairmanship could also be **rotating** on a regular basis to allow each member to serve for an equal period.

Finally, in order to effectively represent the United States, the members of "Team USA" must reach consensus. Therefore, it would be helpful to have a structure in place that strongly encourages the team to reach agreements or to publicly air disagreements, which would be helpful in overcoming regulatory gridlock. If the members of "Team USA" are not able to reach agreement, then the public, stakeholders, state legislators, and Congress should be notified so policymakers could take appropriate steps.

4. The FDIC, the Federal Reserve, and the U.S. Treasury Department should make it a priority to develop an approach tailored to the business of insurance for resolving IAIGs and G-SIIs if and when they fail.

Despite having designated three insurance companies as SIFIs and being granted new resolution authority under Dodd-Frank, regulators have so far mainly focused on resolving retail and investment banks since the failure of these entities are the most prone to causing financial instability. But with the creation of a new federal role in insurance regulation, it is important that federal agencies like the FDIC, the Federal Reserve, and the Treasury Department quickly build up their expertise in, and knowledge of, the business of insurance and the many ways it is different from the business of banking. That includes understanding that insurance companies fail in very different

a This includes 3 SIFIs and 14 SHLCs.

ways from banks and tailoring their policies to account for those differences. These agencies should make the development of insurance resolution policy a priority in the coming months and years.

The task force believes these proposals will help policymakers strike the right balance between global coordination and maintaining the strengths of the current U.S. insurance regulatory system. The task force will issue additional recommendations on global insurance issues in its final paper in 2016.

Appendix A: List of G-SIIs

The most recent FSB list of G-SIIs includes the following nine companies:[63]

Aegon N.V.

Allianz SE

American International Group, Inc.

Aviva plc

Axa S.A.

MetLife, Inc.

Ping An Insurance (Group) Company of China, Ltd.

Prudential Financial, Inc.

Prudential plc

End Notes

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