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CLIENT MEMORANDUM

FIO Releases Report on Modernization and Improvement of U.S. Insurance Regulation

December 13, 2013

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On December 12, 2013, the Federal Insurance Office of the U.S. Department of the Treasury (FIO) released its long-awaited report on how to modernize and improve U.S. insurance regulation. The report, several years in the making, reflects a thorough study of the topic and covers a wide range of issues. Its overarching conclusion is that the days of debating whether federal or state regulation of insurance is preferable should end, and an era of cooperative regulation by regulators at both levels should begin. In its broadest terms, the report prescribes a system in which federal regulation would be more involved in issues of national and international scope, while leaving the bulk of insurance regulation to the states. However, the report also includes a warning that if the states do not act to effectively regulate matters on a consistent and cooperative basis in the near term, in the FIO's view there will be a greater role for federal regulation of insurance.

The report's principal findings are divided between matters of prudential (i.e. solvency) regulation and matters of marketplace regulation. With respect to solvency, the report in general terms looks for greater consistency and transparency across the states, while maintaining a high level of protection for policyholders. The primary recommendations with regard to prudential regulation are as follows:

1. *For material solvency oversight decisions of a discretionary nature, states should adopt a process to get the consent of other states in which the insurer operates.* This recommendation is designed to address situations in which the domestic state regulator grants a permitted practice or other deviation from published accounting rules. The FIO calls not only for transparency about these items, but for buy-in by other state regulators, who might have a different view about the merits of such uses of discretion.

2. *States should establish an independent third-party review mechanism for the NAIC Financial Regulation Standards Accreditation Program.* This proposal, like the first one, is designed to bring greater uniformity to statutory financial statements across states by imposing greater discipline on the process of confirming that accounting rules as adopted meet the requirements for a state insurance department to be accredited.

3. *States should develop a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives.* In one of the more controversial aspects of the report, the FIO recommends that states adopt consistent approaches to the regulation of reinsurance captives and the requirements for obtaining credit for reinsurance for cessions to captives. In the report, the FIO joins New York and some other regulatory voices in calling for better quality of capital for captives and the end of “regulatory arbitrage,” as well as public availability of captive financial statements. The report spends little or no time, however, addressing the redundant reserve requirements that drive many insurers to seek to use captives in the first place.

4. *States should move forward cautiously with the implementation of principles-based reserving (PBR) for life insurers.* The report raises concerns with respect to PBR. First, it questions the ability of the separate states to achieve consistency across states in the application of principles. Second, it points to the greater complexity of PBR over formulaic reserving, and asks whether the 50 states can hire sufficient qualified resources to handle the job.

5. *In the absence of direct federal authority over an insurance group holding company, states should continue to develop approaches to group supervision and address the shortcomings of individual entity supervision.* Although the report cites changes (such as the revised Holding Company Model Act) that are in the process of being implemented, it expresses the view that more can be done. It points to the need for supervisory colleges, but states that such colleges “do not completely substitute for a consolidated regulator.” The report notes that the state of group supervision in the U.S. has drawn international attention, some of it unfavorable. Finally, for those looking for some hope of a stronger federal role, this section of the report concludes with the statement that “Given concerns about the adequacy of solo entity supervision for larger groups, particularly U.S.-based firms operating globally, consolidated supervision for large, internationally-active U.S.-based insurance firms will require continued focus and national attention.”

With respect to direct areas for federal involvement in insurance regulation, the report makes several key recommendations. Principal among these are, first, that mortgage insurers should be federally regulated and overseen from a solvency and business practices perspective. The report points out the strong national interest in housing market conditions and the U.S. government's role in that market, from which it concludes that uniform implementation of robust solvency and business practice standards for mortgage insurance should be part of the overall federal framework. Second, the report recommends that the U.S. Treasury and the U.S. Trade Representative pursue "covered agreements" for reinsurance collateral requirements affecting non-U.S. reinsurers. These agreements would streamline the process of reducing collateral requirements for reinsurance credit for reinsurers in specified jurisdictions, a process the state regulators have been somewhat slow to implement on their own. Further, in an echo of its observations about group supervision described above, the FIO proposes to itself participate in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers.

The report's proposed marketplace reforms are numerous and include:

1. States considering whether marital status is an appropriate underwriting criterion for issuing insurance;
2. States adopting the NAIC's Suitability in Annuities Transactions model regulation;
3. The adoption of "NARAB II," the statute proposed in order to streamline agent and broker licensing across multiple states;
4. State development of standards for the appropriate use of data in personal lines pricing; and
5. Coordination of market conduct exams, with a goal of reducing waste and duplication of efforts.

The FIO report contains a number of other ideas and recommendations and is required reading for anyone with an interest in the future of insurance regulation. It does not set a prescriptive timetable for any of the measures it proposes (which is perhaps not surprising given the delay in producing the report), but clearly looks to the near term as the time frame for moving forward. Our attention now turns to its reception by the state regulators towards whom much of it is directed, as well as to Congress, to see if those two groups have the will to make FIO's recommendations reality.

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