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What FIO Report Means For Future Insurance Regulation

Law360, New York (January 27, 2014, 5:37 PM ET) -- The long-awaited Federal Insurance Office report mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act was finally submitted to Congress and released to the public on Dec. 12, 2013, almost two years after its statutory due date. The report, titled "How to Modernize and Improve the System of Insurance Regulation in the United States," focuses on what it considers to be the shortcomings of the current state-based system of insurance regulation, contending that a "system with 56 independent jurisdictions is inherently limited in its ability to regulate uniformly and efficiently." It also suggests areas for improvement through both state and federal initiatives.

The FIO report emphasizes the need for greater uniformity, asserting that the current lack of uniformity creates inefficiencies and burdens for consumers, insurers and the international community. For example, the report cites a 2009 study by McKinsey & Company that concluded that per dollar of premium, the costs of the state-based insurance regulatory system are approximately 6.8 times greater for an insurer operating in the U.S. than for an insurer operating in the United Kingdom.

Not surprisingly, the FIO report stops far short of recommending that the current state-based insurance regulatory system be replaced by a federal regulatory regime. Doing so would be both politically and practically difficult, as there is significant support for the current state-based system and a federal replacement would require the creation of a federal regulatory body that does not currently exist.

The FIO report acknowledges that the federal government is not currently in a position to displace state regulation completely, and that at the present time, federal involvement should be "targeted to areas in which that involvement would solve problems resulting from the legal and practical limitations of regulation by states, such as the need for uniformity or the need for a federal voice in U.S. interactions with international authorities."

Accordingly, the FIO report takes a two-pronged approach by specifying reforms the office believes are needed within the state-based system of insurance regulation and also identifying specific areas where it believes direct federal involvement is needed.

Although calls for consistency and uniformity resonate throughout the report, the actual recommendations would leave the state-based system essentially intact — for the time being — reflecting the FIO's attempt to walk a political tightrope as a relatively new agency with limited powers in a field with a history going back over 150 years. Even so, the report backs its recommendations for state-based initiatives with the suggestion that "should the states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement."

The FIO report includes 27 recommendations. Two-thirds of the 27 recommendations are calls for action by state regulators. The FIO's recommendations for state-based reforms focus on three areas: (1) capital adequacy and safety/soundness; (2) insurer resolution practices (i.e., issues relating to insurer insolvency) and (3) marketplace regulation. It is an indirect compliment to the National Association of Insurance Commissioners ("NAIC") that many of the FIO's specific recommendations for state action are based on initiatives the NAIC is already pursuing.

The remaining nine recommendations identify areas for direct federal involvement. Those recommendations include, among other things: (1) development and implementation of federal standards and oversight for mortgage insurers, (2) uniform reinsurance collateral requirements based on the NAIC model law and regulation, (3) a national registration system for insurance agents and brokers and (4) FIO participation in supervisory colleges that will oversee large national and internationally active insurers.

Can Uniformity Be Achieved?

The FIO report discusses the challenge of achieving uniformity, given that the regulation of insurance in the United States has historically been the prerogative of the states. The report discusses the role of the NAIC in developing model laws and regulations and in requiring states to adopt key provisions of those model laws and regulations in order to receive and maintain their NAIC accreditation, which is a precondition for much of the deference that state insurance departments give to one another's actions. The FIO report notes that model laws and regulations have not always been uniformly adopted across the states, nor are they uniformly interpreted and enforced even after they have been adopted. And, although the FIO report does not say this, experience has shown that the states that choose to diverge from NAIC models often include some of the most populous and commercially significant states.

The FIO report considers whether it would be beneficial for the federal government to become involved in setting national rules and standards that would preempt state law, while leaving enforcement of the rules and standards to the states. As indicated in the report, however, this approach has its limitations as well. If the federal legislation expresses a vague objective, then implementation by the states is unlikely to be uniform. If the federal legislation contemplates an opt-in by the states, the probability that all states will opt-in may be small. Even where a federal mandate is seemingly clear, achieving uniformity is not easy, given the possibility for 56 different interpretation of the mandate.

Lessons Learned: Past Efforts to Achieve Uniformity

The FIO report reviews a number of previous efforts by the federal government to promote uniformity within the state-based system of regulation, including the Gramm-Leach-Bliley Act of 1999 ("GLBA") and the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA"), which was included in title V of Dodd-Frank.

One of GLBA's provisions set a three-year deadline by which a majority of states would need to enact uniform laws and regulations governing the licensing of insurance agents and brokers (producers), including reciprocity provisions for nonresident licensees. If that deadline had not been met, GLBA would have created the National Association of Registered Agents and Brokers ("NARAB"), a nonprofit organization, to administer multistate producer licensing. Given that incentive, the NAIC developed a Producer Licensing Model Act ("PLMA"), and 35 states adopted its key components by 2002, which meant they did not have to relinquish their authority over producer licensing to NARAB.

Despite the adoption of PLMA by most states, the desired uniformity in the producer licensing process has still not been fully achieved, as some states continue to impose different requirements. As a result, legislation was introduced last year in Congress (the National Association of Registered Agents and Brokers Reform Act of 2013, often called NARAB II) to move forward with the creation of NARAB, empowering it to implement licensing, continuing education and other nonresident insurance producer qualification requirements on a multistate basis.

Another, more recent example of a failed attempt to achieve uniformity through federal legislation is the treatment of premium taxes on nonadmitted insurance. Nonadmitted insurance is property and casualty insurance that is procured — either by an insured directly or through a specially licensed surplus lines broker — from an insurer that is not licensed in the insured's home state. NRRA streamlined the process by which sophisticated commercial purchasers can obtain nonadmitted insurance. It also simplified the regulatory regime by making the insured's home state the sole regulator for nonadmitted insurance transactions.

Those streamlining aspects of NRRA seem to have been largely successful, with one notable exception — NRRA gave the exclusive authority to collect premium taxes on nonadmitted insurance to the insured's home state, while authorizing the states to enter into a compact or otherwise establish procedures to allocate among the states any premium taxes paid to an insured's home state for insurance covering multistate risks.

The congressional intent in NRRA was clearly expressed: "The Congress intends that each State adopt nationwide uniform requirements, forms, and procedures, such as an interstate compact, that provide for the reporting, payment, collection, and allocation of premium taxes for nonadmitted insurance consistent with this section."

However, more than three years have elapsed since NRRA was enacted and no such uniform mechanism is even remotely in prospect. Two competing allocation mechanisms have been developed, one by the NAIC and one by the National Conference of Insurance Legislators ("NCOIL"), and only a minority of states have adopted either one of them. Moreover, in some states, legislation is pending that would establish arrangements different from both the NAIC and the NCOIL proposals.

Commenting on the fate of this aspect of NRRA, the FIO report states: "The NRRA could be a model for insurance regulatory reform because it preserves state regulation but provides incentives for states to act in a manner consistent with federal guidelines."

That expectation seems naive. In fact, viewed solely from the standpoint of incentives, that aspect of NRRA was doomed to fail because its success depended on the willingness of those states that collect the lion's share of premium taxes on nonadmitted insurance to voluntarily relinquish a portion of that revenue to other states — an unlikely prospect, especially in the current environment where states are starved for revenue.

Should Uniformity Trump All Other Goals?

In certain areas of insurance regulation, it is hard to argue against uniformity. Multistate licensing of insurance producers seems to be one such area because it affects the ability of insurance agents and brokers to earn a living and serve their customers across state lines. Another example is the ability of life insurers to bring new life insurance and annuity products to market because those products are sold in a national market and compete with other financial products that are regulated at the federal level. In

fact, variable life and variable annuity products are already subject to federal securities regulation alongside state insurance regulation.

On the other hand, the argument for uniformity is not equally strong in all areas of insurance regulation. State insurance regulators may be better equipped to deal with property and casualty coverages that are tailored to differing environments across the United States — think earthquakes, hurricanes and tornadoes. And while uniformity may produce efficiency and consistency, it would restrict the ability of states to serve as a proving ground for new regulatory ideas or methods.

Supporters of the state-based regulatory system view the ability of states to try different regulatory schemes and learn from each other regarding what is most effective as a unique strength of the current system. The FIO report itself acknowledges the argument that "a state-based system provides better opportunities for experimentation so that the best ideas developed in one jurisdiction can be adopted and replicated in others."

Would Federal Regulation Be a Panacea?

The warning in the FIO report that "should the states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement," seems to assume that a newly developed federal regulatory regime would do a better job than the current state-based system.

The basis for this assumption is unclear. It is not easy to design and implement a new insurance regulatory regime from scratch — a point that has been driven home by the nation's experience with the federal government's efforts to implement the Affordable Care Act. Moreover, the quality of federal decision-making on matters affecting insurance companies is far from self-evident. The recent decision of the Financial Stability Oversight Council ("FSOC") to designate Prudential Financial as a nonbank financial company subject to the supervision of the Federal Reserve has been widely criticized — particularly by the two members of FSOC with insurance regulatory expertise.

The near collapse of American International Group in 2008 — and the resulting emergency federal assistance — is often cited as an example of the need for federal regulation of insurers, but in fact the state-regulated insurance subsidiaries of AIG were quite solvent. The threat to AIG's stability originated from derivatives trading by its financial products division, which actually was supervised by a federal agency, the Office of Thrift Supervision.

In fact, it was the strength of AIG's state-regulated insurance subsidiaries that enabled AIG to recover from the financial crisis and repay the federal government at a profit. Moreover, state insurance commissioners have taken the experience of AIG very much to heart by amending the NAIC Model Insurance Holding Company System Regulatory Act in 2010 to allow insurance regulators to monitor enterprise risks within insurance holding company groups that could affect the insurance companies in the group.

Looking to the Future

What does the FIO report portend for the future of U.S. insurance regulation? It seems clear that the federal government is not ready to take on the challenge of overseeing the $7.3 trillion insurance industry anytime soon. So what can we expect? A great deal depends on how state and federal officials respond to the challenges posed by the report. So here are some observations and suggestions for the

state and federal officials whose actions will shape the future:

State insurance regulation is not going away any time soon.

State insurance regulators collectively operate a system of consumer protection in the United States that probably touches more lives than any other. Many of the state-based actions called for in the FIO report are based on initiatives the NAIC is already engaged in and the FIO report should strengthen the hand of those within the NAIC who are working to advance those initiatives.

Congress and federal regulators need to listen to and learn from state insurance regulators before they act.

Assuming some of the federal initiatives called for in the FIO report come into effect, if they are to have any chance of success — and the same goes for the Federal Reserve's oversight of designated nonbank financial companies — federal officials will need to listen to and learn from the people who have been regulating insurance for the last 150 years. In this regard, it is salutary that the FIO director, Michael McRaith, is a well-respected former state insurance regulator who is well-placed to keep open lines of communication with his former colleagues.

Sometimes a federal solution may be better for everyone.

An example is the allocation of premium taxes on nonadmitted insurance, where the likelihood of all states ever agreeing on an allocation mechanism is remote. On this particular topic, it seems evident that only Congress can impose a solution that will be equitable for all states. That need not be perceived as a "camel's nose under the tent," but rather as a particular solution tailored to an unusual situation where the "have" and the "have not" states are unlikely to ever reach agreement on their own.

Keep an eye on international developments.

Given the increasing globalization of the insurance industry, there will be greater activity from the International Association of Insurance Supervisors, where FIO Director McRaith and two state insurance commissioners are members of the executive committee, and the Financial Stability Board, which has already identified a list of "global systemically important insurers" that it believes should be subject to higher capital requirements and enhanced group-wide supervision. Notably, the one area where Dodd-Frank conferred substantive regulatory authority on the FIO relates to agreements between the United States and foreign insurance regulators.

Transparency is critical.

This applies to both state and federal officials. We are living in an era when the level of public trust in anything that takes place behind closed doors is extremely low. Even when regulators are acting conscientiously in what they believe to be the public interest, if the decision-making process is not perceived as transparent, the legitimacy of the result will be called into question.

State and federal officials need to take a team approach.

For the time being, state insurance regulators are still in the driver's seat when it comes to modernizing and improving the system of insurance regulation in the United States. But the success of that effort will require a collaborative effort by all parties, both state and federal. Concern about turf is inevitable, but

the public interest will be best served if state and federal officials think less in terms of winners and losers and more in terms of partnership, where each participant has a necessary contribution to make to the success of the whole.

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