Research

Developments in the Regulation of Global Insurers: A Primer

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Since the financial crisis, both domestic and international regulators have advanced efforts to revise capital standards and streamline the fragmented international regulatory environment facing large and globally active insurance companies, so-called internationally active insurance groups (IAIGs) and a smaller set of global systemically important insurers (G-SIIs). Given that these "global insurers" and their many subsidiaries serve customers in countries around the world, spanning multiple regulatory jurisdictions, some see value to financial stability in restructuring their supervision; others say that these efforts have intrinsic merit in an increasingly globalized marketplace irrespective of the financial crisis and its implications. This paper briefly highlights the policy issues raised by these regulatory initiatives and explores the potential impacts on the insurance industry and American consumers.

Background

The U.S. is the largest insurance market in the world with $1.3 trillion in premiums in 2013 or 27 percent of the world market.[1] Insurance companies operating in the U.S. are primarily regulated at the state-level. Global insurance groups, however, are active internationally and therefore must comply with the regulatory regimes of every jurisdiction in which they operate. For example, MetLife operates in 50 countries through 359 subsidiaries and AIG operates in 95 countries and jurisdictions.[ii] Despite state-level supervision in the U.S., various regulatory and advisory bodies play a part on the federal level and international stage, and increasingly so since the financial crisis. Their roles are summarized in Table 1.

TABLE 1. THE ROLE OF VARIOUS REGULATORY & ADVISORY BODIES	
GLOBAL	***INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS (IAIS):*** IAIS is a standard setting body whose members represent insurance regulators in nearly 140 countries. In coordination with the Financial Stability Board (FSB) of which it is a member, IAIS is charged with developing the streamlined global regulatory framework for IAIGs and identifying G-SIIs. FIO, FRB, NAIC and state insurance regulators all participate in IAIS and its initiatives.

FEDERAL	***FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC):*** FSOC is a council of America's financial regulators given the task of identifying activities that pose risks to America's financial stability. It has designated 3 insurance companies as systemically important, which then subjects those companies to increased regulation and supervision by the FRB.	***FEDERAL INSURANCE OFFICE (FIO):*** An entity within the Treasury Department, the purpose of FIO is to be a federal level monitor of the insurance industry. Though it has no regulatory oversight powers, it has the potential to effectively represent insurance interests abroad and add insurance expertise to the federal government.	***NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC):*** Serving as a standard-setting body, NAIC's members are the chief insurance regulators of all the states and U.S. territories. Through NAIC, insurance regulators establish best practices, produce model laws, coordinate oversight, and are represented abroad.	***FEDERAL RESERVE BOARD (FRB):*** The FRB is responsible for the regulation of insurance companies designated by FSOC as well as companies with a savings and loan company within the insurance group. These regulations may include higher capital standards, supervision, resolution plans, and other measures.	
STATE	***CHIEF INSURANCE REGULATORS OF ALL 50 STATES, DC & 5 TERRITORIES***: Throughout U.S. history, state governments have been charged with the regulation of insurance companies, a principle enshrined in the McCarran-Ferguson Act passed in 1945. While NAIC coordinates insurance regulation and promotes uniformity, each state has its own insurance commissioner or other regulator responsible for supervising the companies within its borders.				

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed in 2010 to address systemic weaknesses made apparent by the financial crisis, end "too big to fail," and protect consumers from abusive practices by the financial services industry. Insurance companies are widely acknowledged to have weathered the financial crisis better than banks and other financial companies.[iii] In fact, many doubt that most insurance and reinsurance companies pose any systemic risk.[iv][v][vi][vii][viii][ix] Nonetheless, insurance companies have not been immune from efforts to increase capital and regulatory supervision on the federal level.

Dodd-Frank created the Financial Stability Oversight Council (FSOC) to coordinate macroprudential oversight amongst America's financial regulators, and identify and address threats to overall financial stability. Importantly, FSOC was given the power to designate nonbank financial firms (including insurance companies) whose failure would trigger a crisis, label them "systemically important financial institutions" (SIFIs), and subject them to increased regulation by the Federal Reserve Board (FRB).[x] Dodd-Frank also created the Federal Insurance Office (FIO) within the U.S. Treasury Department to monitor the U.S. insurance industry and address the lack of insurance expertise on the federal level. Its director is a nonvoting member of FSOC, serving in an advisory capacity. Since its creation, FSOC has designated three insurance companies as SIFIs—AIG, Prudential Financial and MetLife (which is contesting the designation in court[xi]). The process by which FSOC designated these firms as SIFIs has, in and of itself, been greeted by criticism.[xii] But more pressing for insurers, it is still unclear how FSOC's process will dovetail with regulatory developments on the global stage and how the FRB will apply capital standards for SIFIs.

The New Regulatory Frontier for Global Insurers

Jumpstarted by the Group of 20 (G-20), the Financial Stability Board (FSB), including the affiliated International Association of Insurance Supervisors (IAIS), was tasked with facilitating the coordination and cooperation of insurance supervisors. FSB and IAIS have sought to revise capital standards, identify broad risks to financial markets and their stability, and generally make insurance regulation more efficient and streamlined. These regulatory initiatives, some akin to domestic efforts in Dodd-Frank, are summarized in Table 2 and broadly aimed at three goals: enhanced financial stability, more effective and efficient jurisdictional coordination, and consistent best practices. The initiatives are targeted solely at global insurers, IAIGs and G-

SIIs.

TABLE 2. IAIS REGULATORY INITIATIVES		
INITIATIVE	***DESCRIPTION***	***AFFECTED ENTITITES***
BCR	IAIS completed the Basic Capital Requirement (BCR) in 2014, which is intended to be a uniform capital baseline for applying higher-loss absorbency requirements to G-SIIs on a group basis.	G-SIIs
HLA	IAIS is in the process of developing higher loss absorbency (HLA) requirements that would apply to G-SIIs. G-SIIs will be required to maintain the base capital level mandated by BCR and additional HLA requirements. It is possible that higher levels of capital may be required for non-insurance business or a broad focus area may be considered. IAIS expects to release the HLA requirements for consultation in late June and to complete its work by the end of 2016.	G-SIIs
ICS	The International Capital Standard (ICS) will supplant the BCR as the foundation for the HLA standard for G-SIIs, but will be applicable to all IAIGs as part of ComFrame. IAIS plans to develop the ICS by the end of 2016, with members just beginning implementation in 2019. Numerous policy decisions, such as the approach to take on valuation, remain and field testing must be completed before members begin implementation. IAIS has also noted a transitional period may be needed as individual jurisdictions gradually phase-in requirements.	G-SIIS & IAIGs
ComFrame	The Common Framework for the Supervision of IAIGs or ComFrame, which includes the ICS, is meant to be a comprehensive framework for regulatory supervisors to address group-wide activities and risks. Designed to be integrated and multilateral, the ultimate aim is to make international group supervision more effective and efficient.	G-SIIs & IAIGs

IAIGs are predominately defined by their size (at least $50 billion in assets or gross written premiums of not less than $10 billion on a rolling three-year average) and global reach (premiums written in at least 3 jurisdictions with not less than 10 percent of gross premiums written outside of the home jurisdiction). IAIS has identified about 50 IAIGs globally, of which only a subset are American companies.[xiii]

G-SIIs, in contrast to IAIGs, are identified as posing systemic risk. The IAIS is in the process of revising the G-SII assessment methodology, slated for completion this year.[xiv] In the meantime, nine companies have been identified as G-SIIs—Allianz SE; American International Group, Inc.; Assicurazioni Generali S.p.A; Aviva PLC; AXA S.A.; MetLife, Inc.; Ping An Insurance Company of China, Ltd.; Prudential Financial, Inc.; & Prudential PLC.[xv] American companies AIG, Prudential Financial and MetLife have therefore been identified as both SIFIs and G-SIIs.

For reference, there are more than 6,000 insurers in the United States.[xvi] It is expected that IAIS's initiatives may impact only a handful of the largest and most globally active insurance groups.

The IAIS is scheduled to implement the efforts in Table 2 in 2019. FIO, FRB, NAIC and state insurance representatives all participate in IAIS working groups as representatives of American interests. Yet it is ultimately federal regulators through the FSB who will agree to these standards on behalf of the U.S.

Importantly, however, U.S. law dictates that state-based insurance regulators are responsible for fully implementing the agreements for companies operating within their jurisdiction. Of note, since IAIS is only a standard-setting body, all other countries must also independently implement any final agreement.

Potential Costs & Benefits of a Harmonized Global Regulatory Framework

As with all regulations, developing a coordinated global regulatory framework for insurance groups will have costs and benefits. If new standards require substantially higher capital without additionally harmonizing the fragmented regulatory environment, compliance costs and the cost of insurance coverage may increase while harming coverage expansion and investment.[xvii] On the other hand, proponents of global regulatory efforts argue that, if done right, IAIS's efforts could allow American companies to more effectively compete in the global market, reduce costly inefficiencies and redundancies borne by multijurisdictional regulation, drive down compliance costs, and more comprehensively promote financial stability.[xviii]

Proponents of IAIS's regulatory initiatives generally cite five main benefits:

Global Competitiveness: According to FIO, U.S.-based insurers anticipate 40 percent of revenue coming from outside the country in the coming years.[xix] Additionally, U.S.-based subsidiaries of foreign holding companies are active participants in the U.S. market, accounting for 13 percent of aggregate life/health (L/H) and property/casualty (P/C) premium volume. Developing markets will be a particularly important source for growth in the coming years. In an increasingly globalized marketplace, harmonized rules may help American companies remain competitive internationally.

Reduced Inefficiencies & Complexity: The currently fragmented regulatory environment for insurance groups operating in multiple countries and regulatory jurisdictions can create redundancies and conflicts that raise the cost of doing business. If supervisory roles can be streamlined, coverage costs for insureds may fall. Along with high compliance costs, the complexity of the current regulatory environment may also discourage competition. Regulatory simplification and harmonization could establish a more level playing field; instead of a market dominated by established players who are deep-pocketed enough to sort through the regulatory morass, insurance companies could fairly compete based on the superiority of their products. Ultimately this development would allow for new market entrants, spur domestic companies to grow into new markets, and benefit policyholders.

Comparability: Fragmented regulation of insurance companies and diminished trust in ratings agencies since the financial crisis have necessitated increased due diligence on the part of multinational companies looking to engage with global insurers from different jurisdictions. State guaranty funds were designed largely to protect small business and individual policyholders from losses when an insurance company fails, thus capping payouts at $300,000.[xx] Harmonizing insurance regulations would allow multinational companies to compare solvency, lower search costs, and provide strong insurance partners.

Aligned Standards with the Law of Large Numbers: The insurance industry, unlike banks, is driven by the law of large numbers in which diverse and uncorrelated risks are aggregated; the larger the sample size, the more likely actual losses match expected losses. Existing capital rules, assessed at the legal entity-level and not the group-level, must be calculated in each jurisdiction in which an insurer is operating. This can prevent insurers from effectively deploying capital. If the IAIS process helps move solvency regulation to the group-level, global insurers may more easily employ the law of large numbers, amassing large portfolios of uncorrelated risks to provide cost-effective risk mitigation to policyholders, without trapping capital.

Financial Stability: While some object to the notion that insurance companies as a whole pose any systemic risk, proponents believe IAIS's efforts to implement greater international coordination, prescribe minimum standards, and promote best practices foster financial stability. In this view, the fragmented nature of regulatory

supervision has limited the ability of regulators to perceive systemic risks; an international capital standard assessed at the group-level would remedy those gaps in regulatory oversight.

Primary Issues Raised by Stakeholders

As is to be expected with the potential for such wholesale change in insurance regulation, market participants, academics, and other stakeholders have raised some issues regardless of their support for the IAIS process or not. Following are a number of commonly cited issues:

International standards are duplicative and unnecessary: Some believe that only certain non-insurance activities at the largest institutions warrant any scrutiny greater than currently exists or none at all.[xxi] This line of thinking maintains that because academic literature supports the notion that insurance companies do not pose any systemic risk, internationals standards are simply unnecessary, adding a duplicative and likely conflicting layer of regulation.[xxii]

The IAIS is moving too aggressively and opaquely: IAIS has given itself an aggressive timeline for the development of the initiatives listed in Table 2, though recently softened its language on timing.[xxiii] Some have argued that the timeline is inappropriate considering the number of issues involved in adopting global standards. Kevin McCarty, Florida's Insurance Commissioner and past President of NAIC, testified to Congress, "We have serious concerns about the aggressive timeline of developing a global capital standard given legal, regulatory, and accounting differences around the globe."[xxiv] Concern regarding the speed of the IAIS process is further exacerbated by the perception that IAIS is limiting stakeholder engagement on issues that fundamentally affect the business of insurance.[xxv] Two bills In Congress have recently been introduced partly in response to this line of criticism and to inform the process.[xxvi]

IAIS efforts could lead to a one-size-fits-all capital standard: Many stakeholders have been particularly vigilant at discouraging the adoption of one-size-fits-all or bank-centric capital standards. Kevin McCarty testified to Congress, "We are concerned that taking a uniform regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry."[xxvii]

The current international process appears more favorable to market valuation accounting preferred in Europe: Many believe that the current process appears tilted toward adopting a market valuation accounting approach that is favored in Europe.[xxviii] In a 2013 peer review by the FSB, international regulators faulted the regulation of insurance in America for its lack of uniformity.[xxix] In that report and others, European counterparts have failed to recognize the benefits of America's state-based approach to insurance regulation, particularly for consumers. That lack of recognition and the perception that negotiations currently favor a more European-style accounting approach have engendered concern. State-based regulators have warned that a more European-favored approach could have a negative impact on the U.S. insurance market and hurt consumers because of its volatile short-term focus that differs from the longer-term view taken in the U.S.[xxx] In response to this concern, the IAIS is including U.S. GAAP accounting standards in ongoing field testing of international capital standards, though the issue is not fully resolved.[xxxi]

The international process unduly exerts international pressure on U.S. regulators: As noted by S. Roy Woodall, Jr., the independent member of FSOC with insurance experience appointed by President Obama, in his testimony to Congress, "International regulatory organizations may be attempting to exert what I consider to be inappropriate influence on the development of U.S. regulatory policy."[xxxii] In his view, while state insurance regulators are involved in developing international standards through IAIS, representatives from the Treasury Department, FRB, and Securities and Exchange Commission (SEC) as part of the FSB decide whether to consent to international insurance standards and policy measures.[xxxiii] Yet, ultimately it is state representatives who are responsible for fully implementing any international standards within their jurisdiction.

Without strong coordination, adoption of forthcoming international agreements on insurance regulation could be fragmented to the detriment of U.S. leadership and competitiveness. And in fact, Kevin McCarty, representing state insurance regulators, recently emphasized, "We will not implement any international standard that is inconsistent with our time-tested solvency regime."[xxxiv]

FRB involvement in insurance regulation should concern policymakers: Since the passage of Dodd-Frank, the Federal Reserve Board has become the regulator of approximately one-third of the U.S. insurance industry despite its former role primarily supervising banks.[xxxv] FRB is charged not only with regulating any insurance companies designated by FSOC as a SIFI, but also supervising insurance holding companies that own an insured bank or thrift. Together these companies offer a range of products that until recently FRB had little expertise overseeing. For this reason, some fear that FRB will struggle to tailor regulation for insurance companies.[xxxvi] FRB's role as an insurance regulator may also lead to greater scrutiny by Congress and threaten the Federal Reserve's central bank independence.[xxxvii] Since Congress passed its fix to the Collins Amendment,[xxxviii] the FRB has said that a formal rulemaking is forthcoming on a domestic regulatory capital framework tailored to the insurance business.[xxxix] Representatives from NAIC have encouraged the FRB to be flexible and remember that FRB's standards are in addition to state risk-based capital standards applicable to insurers within FRB-regulated groups and a replacement.[xl] It is further unclear how FRB's recent efforts and involvement on insurance issues will affect IAIS regulatory developments.

Looking Forward

As the previous sections highlighted, stakeholders continue to raise a number of important issues that must be overcome as the IAIS process moves forward and all the costs and benefits are assessed. Importantly, Congress has recently taken a greater interest in the policy issues raised by ongoing regulatory initiatives targeting global insurers, which are still years from adoption. While FRB, FIO and other regulatory officials have promised collaboration and coordination, it is still uncertain how various entities, domestically and internationally, will work together to ensure that consumers are protected and regulations work to promote a level playing field for companies in an increasingly global marketplace.

[1] Swiss Re Sigma, "World Insurance in 2013," (May 2014);
http://media.swissre.com/documents/sigma3_2014_en.pdf