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## **INSURANCE AND REINSURANCE AND FINANCIAL SERVICES AND TAX CLIENT ALERT**

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# **FEDERAL INSURANCE OFFICE RELEASES LONG-AWAITED REPORT**

On December 12, 2013, the Federal Insurance Office (FIO) released its report on [“How to Modernize and Improve the System of Insurance Regulation in the United States”](#) (FIO Report). The FIO Report was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and comes almost two years after its required release deadline of January 2012.

## **OVERVIEW OF FIO REPORT**

The FIO Report examines all segments of the insurance industry except health insurance. It provides a history of insurance regulation in the United States and debate over the need for uniformity in regulation across state jurisdictions. Further, it includes a discussion regarding prudential oversight of the insurance industry, including the Solvency II framework, capital standards, credit for reinsurance, group supervision, and resolution of insolvent insurers. The FIO Report also looks at issues regarding access to insurance, marketplace oversight, and consumer protection.

The FIO Report emphasizes that the debate is not whether insurance should be regulated at the state or federal level, but rather whether there are areas in which “federal involvement in regulation under the state-based system is warranted.” Federal involvement, the FIO Report concludes, “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.” According to FIO Director Michael McRaith, “The report reflects an extensive study of the insurance sector and benefits from the collective expertise and experience of state, federal and international supervisors.”

The FIO Report generally recommends a combination of steps by the states and certain actions by the federal government. Its recommendations include near-

term reform for the states concerning capital adequacy and safety and soundness; insurer orderly resolution practices; and marketplace regulation. States are encouraged to develop more uniform and transparent standards, regulations, and best practices.

More specifically, Director McRaith noted that the FIO Report “recommends a hybrid approach to insurance regulation that provides a practical, fact-based roadmap to modernize and improve the U.S. system of insurance regulation.” The recommended areas for direct federal involvement in regulation include oversight over mortgage insurers, reforms related to market conduct examination, and oversight over rate-related practices and other issues affecting consumers.

## KEY RECOMMENDATIONS

**Capital standards and solvency oversight** are key recommendations in the FIO Report. States are asked to develop cooperative processes that allow the domiciliary regulator to coordinate with regulators in other states in which the insurer operates to improve consistency in solvency oversight. Part of this recommended consistency includes the establishment of an independent, third-party review mechanism for the National Association of Insurance Commissioners’ (NAIC) Financial Regulation Standards Accreditation Program.

Another key recommendation is that states develop a **uniform and transparent solvency oversight regime for the transfer of risk to special purpose reinsurance vehicles by affiliated insurers**. The use of special purpose vehicles (SPVs) in the life insurance market is discussed at length in the FIO Report. Capital and solvency standards are the main concern with the use of SPVs (called insurance captives), where the SPV, according to the FIO Report, does not need to maintain the same capital as the ceding insurer, but the transaction allows the ceding insurer to take full reinsurance credit on its financial statement. The FIO Report concludes that, if an insurer is to receive credit against its capital or reserve requirement because of risk transferred to an SPV, “the rules governing the quality and quantum of assets offered in support of the captive should be uniform across the states and sufficiently robust and transparent in order to prevent arbitrage by insurers.” Interestingly, the FIO Report cites to the New York State Department of Financial Services June 2013 report on the use of SPVs in the life insurance market in support of its recommendations.

**Insurance reserves** is another area of concern in the FIO Report. The FIO Report recommends that states “should move forward cautiously with the implementation of principles-based reserving.” The FIO Report recommends establishing consistent, binding guidelines to determine whether an insurer complies with accounting and solvency requirements, and developing a professional staff and guidelines to review principles-based reserving.

**Credit for reinsurance** has been a major area of debate for years. The FIO Report encourages national uniform treatment of reinsurers and recommends that the Department of Treasury and the Office of the U.S. Trade

Representative pursue agreements for reinsurance collateral requirements based on the NAIC's Credit for Reinsurance Model Law and Regulation.

The FIO Report recommends that the states continue to develop approaches to **group supervision** that address the current shortcomings of solo entity supervision. Supervisory colleges are recommended, in which the FIO would participate to monitor financial stability and identify issues or gaps in the regulation of large nationally and internationally active insurers.

The FIO report also discusses receivership recommendations. The recommendations include adopting a uniform approach to resolving **contracts with counterparties** (derivatives and other qualified financial contracts), developing requirements for transparent **financial reporting** on the administration of a receivership estate, and adopting uniformity on **how policyholders should recover from state guaranty funds**.

The FIO Report also makes recommendations for uniformity on **producer licensing, product approval, suitability of annuities, market conduct examinations, and the appropriate use of personal information for insurance pricing and coverage purposes**. It recommends that states consider whether or in what manner marital status is an appropriate underwriting or rating factor. It also recommends that states monitor the impact of different rate regulation regimes on the various markets to identify best practices that foster competitive markets for personal lines consumers. The FIO did not recommend any action on the nonadmitted and reinsurance markets. However, the FIO Report indicates that FIO will continue to monitor state progress on implementation of the Nonadmitted and Reinsurance Reform Act of 2010 (Subtitle B of Title V of the Dodd-Frank Act) to determine whether federal action may be warranted in the near term. The FIO Report also recommends that states work on best practices to mitigate losses from natural catastrophes.

With regard to **international insurance regulation**, the FIO Report recognizes that insurance regulatory issues will increasingly require international attention and cooperation. Further, it highlights ongoing efforts through the EU-U.S. Insurance Project and the International Association of Insurance Supervisors (IAIS). Of note, the FIO Report does not discuss potential issues that may arise concerning uniform designations of U.S. systemically important financial institutions (SIFIs) and Globally Systemically Important Insurer (G-SII). However, it states that the FIO plans to work with its colleagues to “ensure the rigor and quality of the IAIS methodology, as well as to align the IAIS process” with the U.S. SIFI designation process.

## NEXT STEPS

The insurance industry's initial reaction to the FIO Report reiterated the importance of state-based regulation. NAIC's CEO Senator Ben Nelson noted, “While we appreciate FIO's suggestions for improvement, the states have the ultimate responsibility for implementing regulatory changes.” Similarly, the National Association of Mutual Insurance Companies (NAMIC) CEO, Charles Chamness stated, “As we debate what can and should be done by the federal

government, it is important to remember that the state-based regulatory system, though far from perfect, has performed remarkably well for decades.”

We do not expect any immediate action as a result of the FIO Report. However, the Report serves to indicate some of the main challenges perceived by the FIO (and the Department of Treasury) moving forward. Of note, the FIO does not have regulatory authority and its Report contains “recommendations” that could be understood as advisory statements that will permeate discussions (and potential actions) by state insurance commissioners.

Moreover, most of the FIO Report’s recommendations would require Congressional action. However, the recommendation regarding credit for reinsurance could see the most immediate progress through the Department of Treasury and the Office of the U.S. Trade Representative’s efforts to pursue agreements for reinsurance collateral requirements. Importantly, pursuing such agreements will require extensive and complex negotiations.

As a result of the FIO Report, and as part of its mandate to monitor the insurance industry, we can also expect the FIO to continue asking questions of state regulators regarding reform and modernization initiatives, as well as progress related to the uniformity and transparency of standards and practices.

Additionally, now that this FIO Report has been released, we can expect the FIO to continue working on other overdue reports it has pending. Particularly, the FIO has been discussing other topics such as the Terrorism Risk Insurance Act (TRIA), insurance for natural catastrophic events, and the global reinsurance market.

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Our Financial Services and Tax group continues to advance clients’ interests with the FIO and the Financial Stability Oversight Council (FSOC), in the aftermath of the financial crisis. For additional information regarding the FIO Report and ongoing efforts by the FIO, please contact *Micah Green, John Nonna, Larry Schiffer, Carolyn Walsh, or Mara Giorgio*.