NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
CIPR newsletter

The Year Before Us: Perspectives from NAIC President Ted Nickel

By Ted Nickel, Wisconsin Commissioner of Insurance and NAIC President

◆ Introduction

During my year serving as president-elect of the NAIC, I often thought about how my year as president would go. I imagined I would continue to focus on several key issues initiated by my predecessors, try to make progress on them, and try to keep politics to a minimum. After all, this organization has always managed to focus on important consumer-protection issues such as maintaining state-of-the-art solvency regulation and encouraging the development of competitive insurance markets to provide quality insurance products to the public. I was hoping for a busy and productive year.

Starting in November 2016, unexpected events have caused me to shift my thinking. First was the election of Donald J. Trump as president of the U.S. and his aggressive plan to change the status quo and to return authority to the states. One immediate outcome of the election was an acceleration of progress the Federal Insurance Office (FIO) and the Office of the U.S. Trade Representative (USTR) made on completing the covered agreement between the U.S. and the European Union (EU). Well, the covered agreement has been drafted. And now is the time for state insurance regulators to react to the trade agreement.

President Trump has been active since his inauguration issuing executive orders and memorandums to federal agencies, appointing his cabinet, appointing agency leaders and nominating a candidate to fill a vacancy on the U.S. Supreme Court. While not all of these activities pertain to insurance regulation, many do. Among them are pledges to repeal and replace the federal Affordable Care Act (ACA) and to make changes to the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

So it goes. My notion of a predictably busy and productive 2017 is gone. So far, the pace of change has been almost overwhelming. I expect it will not slow down in the near future. However, in this article, I would like to take an opportunity to share some of my thoughts on important regulatory matters state insurance regulators are facing this year.

◆ Work on the Covered Agreement

In the waning days of the former President Barack Obama's administration, a sense of urgency appeared at FIO and USTR. There was a sense if a covered agreement were to be negotiated, the time was ripe. The Dodd-Frank Act (31 U.S.C. § 314) authorizes the secretary of the U.S. Department of the Treasury (Treasury Department) and USTR to jointly negotiate a covered agreement with one or more foreign governments or regulators. According to the Dodd-Frank Act, a covered agreement is a "written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance."

A covered agreement between the U.S. and EU was achieved. Days before the inauguration, it was announced Jan. 13, 2017, in a letter to the U.S. Congress. State insurance regulators and the NAIC have been critical of the opaque approach toward drafting the agreement. Regardless of the lack of transparency in the drafting process, my fellow insurance regulators are now faced with evaluating the impact of the covered agreement on U.S. insurance consumers and insurers. Perhaps the easiest thing to do would be to block the agreement by portraying it as an unfavorable trade agreement to the Trump administration. However, depending on how it is interpreted, there are some good things contained in the current covered agreement, along with some challenges.

State insurance regulators were told by the negotiators the two goals of the process were to gain equivalence for the treatment of U.S. insurers operating in the EU and recognition by EU of the U.S. insurance regulatory system. In my view, neither was clearly resolved in the covered agreement.

Fellow regulators and I are concerned with the disparate treatment some EU jurisdictions are imposing on U.S. insurers. State insurance regulators are committed to reaching accord on a system of mutual recognition without any jurisdiction imposing its values and regulatory systems on another. Both U.S. and EU insurers deserve to receive fair and equal treatment. There should be no disadvantage to an EU insurer doing business in the U.S. Similarly, a U.S. insurer should not be disadvantaged when it operates in the EU.

While a covered agreement is one solution to resolve these issues, U.S. insurance regulators are opposed to this covered agreement as drafted. We have urged Congress and the Trump administration, with the direct involvement of the states, to seek clarification to ensure that we reach an agreement bringing finality to these issues. The final agreement needs to better protect U.S. consumers, insurers, and the state-based insurance regulatory system. Our system has a long track record of protecting insurance consumers and promoting competitive insurance markets. We have no intention of implementing a Solvency II[1] type regime in the U.S. The U.S. system has been stress-tested and performed much better than Solvency I did in Europe during the 2007–2008 financial crisis. We understand why the EU had to

(Continued on page 3)

[1] Solvency II is a directive in EU law codifying and harmonizing the EU insurance regulatory framework. Primarily, this concerns the amount of capital EU insurers must hold to reduce the risk of insolvency.

change its system, but we intend to resist any efforts to export Solvency II to the U.S.

U.S. insurance regulators can support an agreement that achieves clear and permanent mutual recognition for our time-tested state-based regulatory system, includes meaningful state regulator input and transparency in its drafting and execution, and is unambiguous in its terms and finality. A clarification of the current covered agreement will lead to a better result for the U.S.

◆ "RIGHT-SIZING" THE FEDERAL ROLE IN INSURANCE

One of my most important tasks this year is to see if we can encourage Congress and the Trump administration to take another look at the role of the federal government in the insurance sector. The states have roughly 150 years of experience in regulating the business of insurance and protecting consumers. Regulation has been efficient and effective, designed to protect consumers while monitoring and promoting the largest, most competitive insurance market in the world. Congress, in the Dodd-Frank Act and in prior financial reform efforts before it, recognized the success of state-based insurance regulation by largely deferring to it. Congress however created new authorities impacting the insurance sector and its regulation. In the nearly seven years since passage of Dodd-Frank Act, it has become clear to me changes are needed to better respect the role and strength of the states in regulating insurance. I am hopeful we can clarify the roles of federal agencies in the limited areas of federal involvement, and to eliminate redundant activity weakening effectiveness of our efforts as regulators at home and abroad. We owe it to our nation's consumers—and the vibrant insurance markets of our 56 NAIC-member jurisdictions—to get this right.

Among reforms I would like to see is for Congress to eliminate the FIO. To date, our hopes for a strong and productive partner in the FIO have been disappointing. Its interests seem to regularly be more closely aligned with supporting the International Association of Insurance Supervisors (IAIS) and the EU than with supporting U.S. insurance regulators and the broad spectrum of U.S. companies and consumers. The covered agreement discussed above is one glaring example of this. Roles for which the FIO could provide some value (e.g., housing federal insurance expertise, overseeing the Terrorism Risk Insurance Program and coordinating federal agencies as it relates to insurance), could continue to be filled by the Treasury Department without a stand-alone office or agency. In fact, many of these functions were being addressed by the Treasury Department prior to FIO's creation. While state insurance regulators agree the federal government should have access to insurance expertise, there is simply no need for a stand-alone office to conduct these functions with minimal supervision by more senior administration officials.

One task assigned to FIO was monitoring systemic risk in the insurance sector. FIO has little to offer in this regard. The Financial Stability Oversight Council (FSOC) was created to bring financial regulators together to share information about potential systemic risks within the financial system, including those emanating from the insurance sector. The Treasury is already represented on the FSOC and, indeed, the treasury secretary serves as the FSOC chair. FIO is not a regulator and does not have unique insights state insurance regulators, or others with insurance experience, do not already have regarding risks within the insurance sector.

Any analysis FIO is giving FSOC could be provided by designated individuals within Treasury's other offices, the Federal Reserve and the state insurance departments. Further, neither FIO nor FSOC has devised a way to meaningfully monitor systemic risks created by the various entities. It is leverage employed by commercial banks and investment firms creating risk where it would otherwise not exist. To measure these risks, it is necessary to track them and expose them to all parties. Only then will we, as a nation, be able to measure the danger to the financial system they pose. While insurers might be vulnerable to systemic risk created by others, they do not contribute to systemic risks in the U.S. financial system.

I believe FIO's role in international insurance regulatory standard-setting undermines state insurance regulators and is unnecessary. Prior to establishment of FIO, certain insurance sector participants created a mythology the Treasury Department's involvement in insurance regulatory standard-setting was necessary for the U.S. to "speak with one voice" and to achieve better outcomes for U.S. insurers in those processes. More than six years removed from the passage of the Dodd-Frank Act, neither has occurred. The U.S. now has even more voices at the table than before the Dodd-Frank Act, and standards developed by IAIS continue to reflect a largely European approach to supervision, despite FIO holding several key leadership positions at IAIS, including chair of the Financial Stability and Technical Committee.

Furthermore, the FIO is neither a regulator and nor does it represent regulators, so its significant involvement in regulatory standard-setting undermines U.S. state regulator independence and authority. To the extent the Treasury Department needs to engage internationally with foreign governments and entities on insurance matters, the Treasury Department has an entire Office of International Affairs equipped to do so that has a long history of effective cooperation with state regulators.

(Continued on page 4)

The FIO's information-gathering authorities are also redundant. Every state insurance regulator, supported by NAIC when needed, has comprehensive powers and tools to collect information and share it with the federal government, as appropriate. Having a duplicative federal data-collection authority creates unnecessary burdens and resource constraints for regulators and the industry. State insurance regulators and NAIC have always been responsive to requests from federal agencies for information that is necessary for the agency to carry out its functions.

My colleagues and I are recommending we engage Congress in serious discussions about the need to reform the FSOC to reduce actual, rather than perceived systemic risks to the U.S. financial system. This would include reforming FSOC's designation process, which has designated three insurance firms (AIG, Prudential and MetLife) as systemically important financial institutions (SIFIs). Little is understood about the reasons for the designations. Even less transparent is the process applied to reduce the firms' perceived risks to the financial system and thus create an off-ramp for SIFI designation removing. In fact, insurance regulatory representatives and an independent member with insurance expertise—the only two insurance experts independent from Treasury—have called into question the analytical rigor of these designations. A U.S. district court judge has overturned the MetLife designation, which is under appeal.

Serious reform of FSOC's designation authority is needed to ensure FSOC is focused on reducing systemic risks to the financial system, not just duplicating regulation. Such reforms should include, at a bare minimum, giving more deference to views of primary regulators of firms, as well as ongoing regulation of such firms, eliminating gross speculation from analysis underpinning the basis for nonbank designations, providing clarity as to the reasons for designation, providing for an off-ramp for designations and allowing firms to submit de-risking plans for review.

State insurance regulators should also have a vote on FSOC. FSOC is charged with monitoring systemic risk throughout the U.S. financial system, including the insurance sector. To ensure insurance perspectives are adequately represented in discussions, state insurance regulators, as primary functional regulators of the U.S. insurance sector, should have a voting seat on FSOC just like functional regulators of other financial sectors.

Banking regulators are good at regulating banks; however, problems arise when banking regulators attempt to regulate insurers as if they are banks. The Federal Reserve's supervision of savings-and-loan holding companies should focus on protecting the thrift. With respect to insurance holding companies with thrifts, the Federal Reserve Board should reconsider regulating every subsidiary with umbrella supervision designed for large bank holding companies and should focus on risks to the thrift or the Federal Deposit Insurance Fund Proportionality is key here.

Let me be clear, we support constructive working relationships with key federal agencies to advance the interest of the U.S. market and consumers but we have some issues with various federal agencies.

◆ CYBERSECURITY

Cybersecurity risks have become more significant as critical consumer financial and health information is increasingly stored in electronic form. As people become more reliant on electronic communication, and as businesses collect and maintain ever more granular pieces of information on customers, opportunities for bad actors to cause difficulties for businesses and the public is exploding. Recent high-profile data breaches have led state insurance regulators to work toward strengthening insurer defenses against attacks.

In late 2014, the Executive Committee appointed the Cybersecurity Task Force to serve as a central focus for insurance regulatory activities related to cybersecurity. State insurance regulators are committed to developing tools to ensure the effective regulation of insurers and insurance producers to protect consumers. In addition, NAIC is working toward developing an *Insurance Data Security Model Law* which establishes standards for data security. This model includes establishing standards for investigating a data breach and providing requirements for notifying regulators and consumers. NAIC has already developed a *Roadmap for Cybersecurity Consumer Protections* and *Principles for Effective Cybersecurity: Insurance Regulation Guidance*. These documents serve as a foundation for building the Insurance Data Security Model Law.

The Cybersecurity Task Force formed a drafting group consisting of several state insurance regulators, trade and industry groups, and consumer representatives to work on a third draft of the proposed *Insurance Data Security Model Law*. The drafting group has been meeting regularly since November 2016.

There are six important issues on which the drafting group would like to reach consensus: 1) how to address state uniformity; 2) whether and how to include an exemption for licensees subject to federal HIPAA or the federal Gramm-Leach Bliley Act; 3) whether definition of the term "data breach" should include a harm trigger; 4) how to define "personal information"; 5) how to address scalability of

(Continued on page 5)

information security requirements for smaller licensees; and 6) how to address licensee oversight of third-party service providers.

I am confident the Cybersecurity Task Force will complete its work on the model law and continue to serve as the coordinator of NAIC cybersecurity efforts. The drafting group is making progress and hopes to have a third draft exposed for comment in the near future.

On another front, demand for cybersecurity insurance policies has increased significantly in response to sharply heightened risk awareness among American businesses and consumers. However, managing cyber risks through insurance is relatively new. Although the market for cybersecurity insurance is off to a good start, it is expected to grow dramatically over time as businesses gradually become more aware their current business policies do not adequately cover cyber risks. With each announcement of a system failure leading to a significant business loss, awareness grows. This growing awareness has stimulated demand for cybersecurity insurance products.

The Cybersecurity Task Force worked with the Property and Casualty Insurance Committee and the Financial Condition Committee to develop the Cybersecurity and Identity Theft Insurance Coverage Supplement for insurer financial statements to gather financial performance information about insurers writing cybersecurity insurance coverage nationwide. Early analysis showed in 2015, more than 500 insurers provided businesses and individuals with cyber insurance in the U.S. A Vast majority of these coverages were written as endorsements to commercial and personal policies. There are also a significant number of non-U.S. surplus lines insurers writing cyber-risk coverages. NAIC also updated its *Financial Condition Examiners Handbook* and will be updating its *Market Regulation Handbook* to better reflect processes and procedures for monitoring insurer cybersecurity efforts.

In 2017, I am hopeful work will be finished on the model law, and I am looking forward to what we will learn about cybersecurity insurance markets from the 2016 annual financial statement filings.

◆ RETIREMENT SECURITY

I am concerned with the state of retirement security for many Americans. While this is not entirely an insurance matter, it is important for state insurance regulators to contribute toward making education on retirement security a priority and promoting insurance products available to assist consumers to be better prepared.

The statistics are frightening. Fewer than 50% of all American families have a retirement account, and the median value of those who have retirement accounts is under \$60,000.[2] Further, among families where the head of household is between 55 and 64, only 59% have a retirement account. In these accounts, the median value is slightly more than \$100,000. When the cost of retirement averages \$700,000, it is obvious many are underprepared.

With 40 percent of the soon-to-retire population destined to rely solely on Social Security and half of the remainder saving less than \$100,000 to supplement their Social Security benefits, this shortfall is overwhelming. It is highly likely there will be calls to provide government benefits to those who failed to plan adequately for retirement. I am hopeful we can resist these calls and instead encourage people to set aside sufficient savings for their futures. Additionally, we will continue to work to ensure both domestic and international standard setting don't harm the ability of insurers to offer the insurance products and services Americans will need in order to plan and save for retirement.

As I mentioned earlier, inadequate saving for future retirement is not entirely an insurance problem. There are things people can do; for example, maximize the funding of defined contribution pension plans, such as 401(k), 403(b) and 457 plans. It is particularly important for employees to at least contribute the minimum amount to secure the employer match when it is available. Remember, the earlier you start to save for retirement, the more likely you will be able to obtain a secure financial future.

Social Security and pension plans provide basic building blocks of a secure retirement. To supplement these building blocks, insurance products should be part of a comprehensive retirement plan. This is why NAIC is working to both protect and educate consumers, while stepping up its efforts with insurance industry participants to encourage innovation.

NAIC's Retirement Security Initiative includes a three-pronged strategy: 1) education; 2) consumer protection; and 3) innovation. This approach allows state insurance regulators to identify practical regulatory or policy issues in need of review, as well as highlight barriers to innovation, product delivery and compliance. Consumer outreach will bring into focus areas in need of improved understanding and access. Regulatory functions coordinated through NAIC

(Continued on page 6)

[2] Federal Reserve Bulletin, September 2014. www.federalreserve.gov/pubs/bulletin/2014/default.htm

will continue to monitor for best practices regarding suitability, fair treatment and compliance.

NAIC has developed a microsite on its web page encouraging people to Get Smart About Retirement Security.[3] I urge you to visit this site and review information available to help guide your retirement security efforts.

We are committed to enhancing retirement security through education, consumer protection and innovation. Please join us in this journey.

◆ The Impact of Innovation on the Insurance Sector

In early 2017, NAIC introduced the Innovation and Technology (EX) Task Force. Its mission is to provide a forum for discussion of innovation and technology in the insurance sector, to monitor technology developments impacting state insurance regulatory framework, and to develop regulatory guidance as appropriate.

I anticipate this Task Force will develop a large constituency of state insurance regulators and interested parties with an interest in learning about the latest innovations and attempting to assess how innovations will impact their current business model. Three existing groups will report to this new Task Force: Cybersecurity Task Force; the Big Data Working Group; and the Speed to Market Task Force. Each will become a working group under our new Innovation and Technology Task Force.

NAIC members will participate in Task Force forums for discussion of innovation and technology developments in the insurance sector in order to educate regulators on how these developments impact consumer protection, insurer and producer oversight, and the state insurance regulatory framework. Other Task Force discussions will explore regulatory issues arising from development of autonomous vehicles and discuss emerging issues related to on-demand insurance applications.

One school of thought argues perhaps our current regulatory framework is rigid and insurance laws might prove to be a barrier to some of these innovations and new delivery systems. For example, laws dealing with cancellations, nonrenewals, coverage issues, notice provisions and policy delivery requirements were developed at a time when insurance contracts were written documents. Powerful personal computers capable of instantaneous communication by phone, email and text with ubiquitous access to the Internet did not exist. For an on-demand insurance application where a consumer can "slide right" to activate coverage and "slide left" to turn it off, does it really make sense to have a 10-day notice of cancellation as a required contractual provision?

I am enthusiastic about all of the innovators who have approached me to share their ideas and show me their products. I encourage my fellow insurance regulators to keep an open mind and try to find ways to assist these innovators as they try to bring their products to market. During my tenure as NAIC President, I am hopeful we can set up a "sandbox" concept to provide innovators with a forum to run their ideas past a group of state insurance regulators who will provide valuable feedback and help those innovators identify pitfalls before they find them by accident.

◆ Implementation of Principle-Based Reserving

Principle-based reserving (PBR) can be a confusing topic for many. For others, it has been under consideration for so long they are bored with it. I would like to take this opportunity to add a bit of clarity for those who have not followed PBR development closely.

Let's start out with what it is. First, it is significant change in underlying laws and regulations to solve a problem created by our current regulatory framework. The issue lies with laws and guidance on how a life insurer is required to book its reserves. Insurers set aside funds, known as reserves, to pay insurance claims when they become due. Currently, static formulas and assumptions are used to determine these reserves. They are prescribed by state laws and regulations. This process is known as rule-based or formulaic reserving. Sometimes, rule-based reserving results in a perfect answer; however, sometimes a rule-based approach leaves an insurer with excessive reserves for certain insurance products and inadequate reserves for others. The solution is to "right-size" reserve calculations by replacing a rule-based approach with a principle-based approach.

Under PBR, insurers will be required to hold the higher of (a) reserves using prescribed factors or (b) reserves which consider a wide range of future economic conditions and is computed using justified insurer experience factors specific to an insurer, such as mortality, policyholder behavior and expenses.

There are two key building blocks needed for PBR to come to fruition. They are adoption of NAIC *Standard Valuation Law* (#820) and *Valuation Manual*. NAIC adopted amendments to Model #820 in 2009, introducing this new method for calculating life insurance policy reserves. PBR replaces current rule-based approaches to determining policy reserves with an approach more closely reflecting risks of highly complex products. This improved calculation is expected to right-size reserves; i.e., reduce reserves set too high for some products and increase reserves set too low for other products.

(Continued on page 7)

[3] www.insureuonline.org/insureu_retirement_security_resources.htm.

NAIC adoption of the *Valuation Manual* referenced in the 2009 version of the Model #820 marked a major milestone in moving from formulaic rules to PBR. The *Valuation Manual* begins this process of revising reserving requirements to be more dynamic to meet needs for today's variety of products and helps to mitigate any need for insurers to modify products in ways which avoid formulaic regulatory requirements. The *Valuation Ma*nual was initially adopted by a supermajority of NAIC members in December 2012, which paved the way for the states to begin enacting the revisions to Model #820 in their legislative sessions.

Our agreed-upon threshold for PBR implementation was when at least 42 states representing at least 75% of total U.S. premium had enacted the revisions to Model #820 using substantially similar terms and provisions. On June 10, 2016, NAIC members met the threshold to make the *Valuation Manual* operative. NAIC adopted a recommendation for the states with the enacted revisions to Model #820 to activate PBR on Jan. 1, 2017. As of Dec. 1, 2016, 46 states have revised their model laws, representing 85.7% of the U.S. life insurance market. This marked an historic accomplishment and beginning a new policy valuation system which will adapt to new and innovative life insurance products benefiting consumers and life insurers.

I am happy we have moved to the implementation phase of this project.

◆ HEALTH INSURANCE ISSUES

"Who knew health insurance was so complicated?" President Trump asked in a recent tweet. Answer: state insurance regulators have known this for a long time. There are no easy answers to making insurance affordable and available to all while providing broad, comprehensive health insurance products to every American.

Like a balloon, if you squeeze one side, something pops out on the other side. Eliminating preexisting condition exclusions raises prices. So does eliminating policy maximums. Each of these benefits is widely viewed as important steps forward in consumer protection. However, each new benefit comes with a price.

The ACA relied on the coverage mandate to bring young people into the system to support these added benefits and age rating restrictions.

This year, the political phrase is "repeal and replace." However, to repeal and replace without significant dislocations appears to be a challenge. State insurance regulators stand ready to assist the Trump administration as it makes its way through a myriad issues to arrive at a plan ensuring coverage for all Americans, keeping the important consumers protections recognized by President Trump as popular with the American public and worthy of continuing. As always, state insurance regulators will serve as experts and neutral sources of information on how the proposals might impact health insurance markets and consumers.

◆ ENGAGEMENT ON INTERNATIONAL STANDARD-SETTING

The U.S. insurance market is the largest and most competitive in the world. More than 5,900 insurers operate here, with assets of almost $8 trillion and more than $2 trillion in annual premium. The insurance sector employs 2.2 million people directly and provides investment capital to fund local infrastructure projects, which also provide jobs. Twenty-five U.S. states are among the world's 50 largest insurance markets, and collectively states play a prominent role in promoting growth and preserving strength of the U.S. insurance sector, which, in turn, supports financial risk management and growth in all sectors.

NAIC has a long history of engagement with our international regulatory counterparts. In fact, NAIC was instrumental in the formation of what is now known as the IAIS. IAIS was formed in 1994 and NAIC served as its secretariat during its formative years. IAIS later moved to Switzerland and hired its own staff. International organizations based in Europe, including the Financial Stability Board (FSB) and IAIS, are working to develop global standards which may be well-intentioned in theory, but ineffective in practice. Moreover, in some cases, global standards may be inconsistent with current U.S. policy, our state-based system of insurance regulation, and best interests of U.S. consumers and U.S. insurance industry.

NAIC has enabled states to coordinate domestically and internationally for many years, and the state-based system's track record has been excellent for protecting policyholders and maintaining stable and competitive markets. I should note the system in the EU (i.e., Solvency II) is not based on protecting consumers and encouraging strong competitive markets, but, rather, on requiring sufficient capital so no insurer becomes insolvent. Further, much of the IAIS regulatory work is done in closed meetings, while the U.S. state-based regulatory system operates with a great deal of transparency. It is a fundamentally different approach to regulation.

Congress recognizes state insurance regulators oversee 100% of U.S. private insurance market and are engaged in international leadership roles as group-wide supervisors who coordinate oversight of large complex U.S. insurance groups operating across many jurisdictional borders. While NAIC and its members are effectively the largest member of

(Continued on page 8)

IAIS, FIO and the Federal Reserve are also members, each with their own objectives, more narrow authorities and more limited insurance experience. FIO and the Federal Reserve are also members of FSB, which excludes state insurance regulators and NAIC.

State insurance regulators, legislators, policyholders and insurers have all called for greater transparency in the discussions and decisions of FSB and IAIS, as well as more accountability in activities of the Treasury Department and the Federal Reserve Board on international insurance matters.

Congress has an important role to play in overseeing U.S. policy on international efforts to develop global standards for regulating the insurance sector, and, in particular, roles and objectives of Treasury and the Federal Reserve, because both are deeply engaged in decisions of FSB and IAIS. Although international standards are advisory only and non-binding, they nevertheless could be implemented in many jurisdictions and ultimately impact competitiveness of the U.S. insurance sector.

NAIC and its members would welcome more support from the Treasury Department and the Federal Reserve, but many state government officials share a general concern federal objectives are not closely aligned with the state-based regulatory system, which provides policyholder protections and maintains stable and competitive insurance markets.

Many U.S. stakeholders and state insurance regulators continue to question whether some aspects of proposed international standards are warranted, given the current financial strength of the insurance sector. Potential costs of new global group capital standards could discourage long-term investment and limit the variety of insurance products available.

The U.S. insurance market remained stable and competitive during the 2007–2008 financial crisis. Today, policyholders are well-protected and insurers are well-capitalized. NAIC members believe in the enduring quality of our national system of state-based regulation, and we appreciate strong support in Congress for states on insurance matters.

All we are asking of our international counterparts is mutual recognition of each other's regulatory frameworks. We should not try to push our system on them and, in return, they should not attempt to impose their largely untested system on us.

◆ SUPERVISION OF INSURANCE GROUPS

The solvency framework of the U.S. system of state-based insurance regulation has included a review of the holding company system for decades, with an emphasis placed on each insurance legal entity. In light of the 2007–2008 financial crisis and the globalization of the insurance business models, state insurance regulators have begun to modify their group supervisory framework and have been increasingly involved in developing an international group supervisory framework.

Under our U.S. system of state-based insurance regulation, the need for group supervision was recognized early on, with the first NAIC model law adopted in 1969. While changes have been made in model laws since that time, the general principles of group supervision, as reaffirmed in the 1978 NAIC *Proceedings*,[4] still remain. The U.S. approach to group supervision adopted in the NAIC *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions* (#450) has been described as a "windows and walls" approach. Regulators have "windows" to scrutinize group activity and assess its potential impact on the ability of an insurer to pay its claims and "walls" to protect capital of an insurer by requiring the insurance commissioner's approval of material related-party transactions.

During the financial crisis, the U.S. group supervisory framework was tested when American International Group (AIG) faced financial uncertainty. In 2008, the AIG financial holding company was comprised of 71 U.S.-based insurance entities and 176 other financial services companies throughout the world. AIG's Financial Products unit based in London, a non-insurance component of AIG's holding company system, was described by Federal Reserve Chairman Ben Bernanke as making "huge numbers of irresponsible bets" with risky investments and taking on "huge losses." The U.S. Office of Thrift Supervision, a federal banking regulator, was charged with supervising the AIG holding company. The national system of state-based insurance regulation in the U.S. protected policyholders during the AIG crisis via the walls and provided options to insurance commissioners as they worked with banking regulators to work through AIG's holding company system's financial issues.

The contagion effects experienced by U.S. insurers in AIG's holding company system's near collapse caused U.S. insurance regulators to reevaluate their group supervisory framework. Beginning in 2008, through the NAIC Solvency Modernization Initiative (SMI), U.S. insurance regulators reviewed lessons learned from the financial crisis, and, specifically, studied AIG and potential impacts of noninsurance operations on insurance companies in the same group. Through the SMI, U.S. insurance regulators devised plans for revisions to group su-

(Continued on page 9)

[4] NAIC Research Library.

pervision, maintaining the walls but enhancing the windows of the system. Concepts addressed in the enhanced windows and walls approach include: 1) communication between regulators and supervisory colleges;[5] 2) access to, and collection of, information from groups; 3) enforcement measures; and 4) group capital assessment.

To enhance systems for group supervision, NAIC adopted revisions to Model #440 and Model #450 in 2010. The revisions included: 1) expanded ability to evaluate any entity within an insurance holding company system; 2) enhancements to the regulator's rights to access books and records and compelling production of information; 3) establishment of expectation of funding with regard to regulator participation in supervisory colleges; and 4) enhancements in corporate governance, such as responsibilities of board of directors and senior management. Additionally, state insurance regulators adopted an expansion to the Insurance Holding Company System Annual Registration Statement (Form B) to broaden requirements to include financial statements of all affiliates. A new Form F (Enterprise Risk Report) was also introduced for firms to identify and report their enterprise risk.

In addition, state insurance regulators put into effect the international concept of the Own Risk and Solvency Assessment (ORSA) on Jan. 1, 2015. Pursuant to NAIC's *Own Risk and Solvency Assessment (ORSA) Guidance Manual* and the NAIC *Risk Management and Own Risk and Solvency Assessment Model Act* (#505), large and medium-size U.S. insurers and insurance groups are required to regularly perform an ORSA and file a confidential ORSA Summary Report of their assessment with regulators of each insurance company upon request, and with the lead state regulator for each insurance group regardless of whether a request is made. Model #505 provides requirements for completing an annual ORSA and provides guidance and instructions for filing an ORSA Summary Report.

Lessons about group supervision are lessons insurance supervisors worldwide have learned. It is an element of the EU Solvency II directive and is being discussed at IAIS. As part of enhancements to international supervisory cooperation and coordination, U.S. insurance regulators are working with IAIS on a number of work streams. IAIS has been focused on improving group supervision internationally through three main initiatives: 1) standard-setting; 2) Supervisory Forum; and 3) Common Framework for Supervision of Internationally Active Insurance Groups (ComFrame). State insurance regulators have been, and continue to be, actively engaged in all of these initiatives.

◆ BIG DATA

Big data has become a buzzword, although there is often disagreement about what the term means. The formal definition, according to Wikipedia is: "Big data is a term for data sets so large or complex traditional data processing applications are inadequate. Challenges include analysis, capture, data curation, search, sharing, storage, transfer, visualization, querying, updating and information privacy." Other sources define it differently. A common thread seems to be big data involves lots of data and, because it is so large, it is complicated to use and difficult to understand.

Insurers are collecting more granular data about consumers. They also have begun to rely on nontraditional data sets to provide insight about their customers. Insurance regulators need greater insight into what data is available to insurers, how the data is being used and whether the use is appropriate from a compliance perspective. Insurers are known to use big data to assist in underwriting, pricing, marketing and claim settlement. To help ensure fair and competitive insurance markets, state insurance regulators are obliged to monitor insurers' use of big data. Regulators understand competitive markets function more efficiently when both buyers and sellers are well-informed. As regulators, we are concerned opaqueness of big data encourages markets to operate less efficiently than they would with greater transparency to all parties.

State insurance regulators' interest in insurer use of big data is based in statute. We need to understand whether an insurer's use of big data in pricing causes compliance issues or creates a substitute variable which would not otherwise be acceptable to the public. Further, we are interested in being able to effectively communicate with the public about data insurers use to establish prices or decide to whom coverage offers are being made. We also need to know how insurers are safeguarding data and impacts on consumer privacy.

State insurance regulators currently collect substantial amounts of financial and market data from insurers. As use of big data evolves, we might need to collect additional data to allow us greater insight into insurer practices. This will ultimately enhance the efficiency and effectiveness of insurance regulation. I am hopeful collaboration between insurers and state insurance regulators will result in a more transparent process where consumers and insurers will benefit from a more competitive marketplace for insurance products.

The Big Data (EX) Working Group will address three priorities this year. The Working Group is asked to review the regulatory framework used to oversee insurers' use of data. The Working Group is tasked with developing a proposal for the states to share regulatory resources to facilitate the review of insurers' complex models used for rating, underwriting and claims. The Working Group will also assess data

(Continued on page 10)

[5] www.naic.org/cipr_topics/topic_supervisory_college.htm

needs and required tools for state insurance regulators to efficiently and effectively monitor the market.

◆ THE EVOLUTION OF LONG-TERM CARE INSURANCE PRODUCTS

The long-term care insurance market has evolved significantly since its introduction in the 1960s. In the past decade, the market has grown from covering less than three million lives to now covering more than seven million lives. According to the U.S. Department of Health and Human Services (HHS), about 12 million of America's senior citizens will require long-term care by 2020.

Early long-term care insurance (LTCI) policies were intended to supplement payment for the primary form of long-term care at that time; namely, nursing homes. LTCI policies now incorporate myriad long-term care service alternatives, including home health care, respite care, hospice care, personal care in the home, services provided in assisted living facilities, adult day care centers and other community facilities. Public programs, such as Medicare and Medicaid, also cover certain long-term care services. As our population ages, the need for long-term care support and services will become increasingly important and require innovative new approaches.

As illustrated in a recent study by the NAIC's Center for Insurance Policy and Research (CIPR), there are two key factors driving life insurance product development: 1) mortality risk; and 2) longevity risk. In recent years, product focus has shifted to address longevity risk as baby boomers reach retirement age at a time when defined benefit pension plans are vanishing. As the general health of population improves over time, people are living longer. The blessing of a longer life is accompanied by a need to generate sufficient income in retirement to be able to enjoy extra years and pay for long-term care if it becomes necessary. I discussed retirement security earlier. This section will focus on LTCI challenges.

The primary challenges for insurers and state insurance regulators in LTCI markets relate to unknowns. When early LTCI products were developed, actuarial assumptions were made about longevity and persistency are proving to be inaccurate. First, insurers underestimated how long people would live. As people lived longer, the likelihood they would need to call upon LTCI polices for coverage increased. As it became apparent the actuarial longevity estimates were wrong, the solution of choice seemed to be to raise rates. This answer proved to be difficult, as often the additional premium would be sought from those on fixed incomes and least able to afford it.

Another assumption made by actuaries related to persistency. In other words, actuaries assumed many people would drop their coverage over time. This proved not to be the case, as dropping a policy meant the consumer would receive nothing in return for premiums paid over time.

An additional unknown was the extent of the incidence of cognitive memory disorders such as Alzheimer's disease. People can live for a long time with Alzheimer's disease and similar memory challenges. If a cure were to be found, the cost for LTCI products would drop significantly.

So far, you are probably depressed about prospects for LTCI. I would like to share with you what NAIC and its member states are working on to make things better. We are working to enact protections designed to keep abreast of changes in product design and to address historical problems encountered in the marketplace. NAIC membership adopted amendments to the *Long-Term Care Insurance Model Regulation* (#641) in August 2014 aimed at improving rate-stabilization provisions. NAIC is producing and evaluating proposals related to LTCI rate stability for existing policies; developing a new mortality standard for long-term care reserves based on the 2012 Individual Annuity Reserving Tables; developing new tabular voluntary lapse standard for long-term care reserves; working with interested parties to determine the appropriateness of a principle-based framework for LTCI valuation; and developing regulatory guidance for premium deficiency reserve calculations.

Additionally, the NAIC Senior Issues Task Force is taking a broad look at recent changes in the LTCI market, including shifts in the profile of purchasers, evolution of types of products being sold, other changes in the marketplace and goals of regulation of this product. The Task Force created the Long-Term Care Innovation Subgroup in 2016 to examine the future of LTCI, what type of LTCI products should be on the market going forward, and who is likely to buy these products. The LTCI benefits of insolvent insurers are covered under the NAIC *Life and Health Insurance Guaranty Association Model Act* (#520). The NAIC Receivership and Insolvency Task Force will address issues and concerns with guaranty fund coverage developing as a result of new or ongoing discussions and work occurring in other LTCI groups.

There also have been public hearings and the release of a CIPR study, *The State of Long-Term Care Insurance: The Market, Challenges and Future Innovations*.[6] The study provides a detailed overview of the state of the LTCI market, the economics and benefits of private long-term care insurance, the future demand of improved LTCI, long-term care reform proposals and regulation of LTCI rates.

(Continued on page 11)

[6] www.naic.org/documents/cipr_current_study_160519_ltc_insurance.pdf

◆ FLOOD INSURANCE

State insurance regulators are keenly aware of the catastrophic impact floods have on millions of citizens and many communities across the nation. Like other disasters, flood can have devastating impacts on those in harm's way. It is critical flood insurance be available to all those who need it. It also must be affordable if we expect the public to purchase it. Currently most flood insurance is sold through the National Flood Insurance Program (NFIP).

This year, state insurance regulators will be focused on flood insurance for two reasons. First, NFIP is scheduled to sunset on September 30, 2017. It is imperative for the U.S. Congress to reauthorize NFIP so coverage for the flood peril is available to Americans. In past years, the U.S. Congress has failed to act until very near the sunset date. In some cases, action occurred after the program sunset. This causes problems for homeowners, potential home buyers, mortgage lenders, insurers and the U.S. economy. The second issue is the increasing interest from the private sector in writing flood insurance coverage. State insurance regulators view this as a positive development as it promotes a competitive insurance market and offers alternatives to consumers seeking coverage.

Reauthorization of the National Flood Insurance Program

NFIP authorization expires on Sept. 30, 2017. State insurance regulators have collectively, through the NAIC, voiced their support for a long-term reauthorization of NFIP to avoid short-term extensions and program lapses creating uncertainty in the insurance, housing and mortgage lending markets.

The NAIC Property and Casualty Insurance Committee developed a number of recommendations to the NAIC Government Relations Leadership Council to convey to Congress as it considers potential changes and improvements to NFIP as part of the reauthorization process to address the country's flood risk. Recommendations are captured in the following NAIC principles:

- Encourage greater growth in the private flood insurance market as a complement to NFIP to help provide consumers with more choices.
    - Support the Flood Insurance Market Parity and Modernization Act (H.R. 2901/S. 1679) which clarifies private flood insurance meets the mandatory purchase requirement and that state insurance regulators have the same authority and discretion to regulate private flood insurance as they have with other similar insurance products. The Act also makes clear private flood insurance meets the continuous coverage requirement so policyholders have a choice to return to the NFIP without penalty, including not losing any subsidy they previously had with the NFIP.
    - Require FEMA to reinstate its prior rules allowing policyholders to cancel their NFIP policies mid-term and receive refunds on a pro-rated basis if they decide to replace their NFIP policies with private flood insurance.
    - Require FEMA to share NFIP information, including claims, elevation, and mapping data, with state insurance regulators, insurers, modelers, advisory, statistical and rating organizations in order for the private market to be able to accurately assess flood risks.
    - Require FEMA to eliminate the non-compete clause to allow the Write Your Own (WYO) insurers to sell private flood insurance outside of NFIP.
- Review current NFIP training requirements for insurance producers in consultation with state insurance regulators who are tasked with licensing producers who sell NFIP policies. Ensure any NFIP training is accurate and consistent with regard to the existence and availability of private flood insurance.
- Encourage support for mitigation planning, including mitigation discounts, such as premium discounts or insurance rate reductions to persons who build, rebuild, or retrofit certain residential properties to better resist flood events, and legislative efforts such as the Disaster Savings Accounts Act (H.R. 2230) to allow individuals to set aside funds in a tax-preferred savings account for disaster mitigation and recovery expenses.
- Encourage careful consideration of affordability issues and the impact of NFIP policy changes on current NFIP policyholders. Certain actions should be considered within the reauthorization to address affordability, for example, potentially including continuation by FEMA of its NFIP grandfathering provisions or implementing means-tested discounts coupled with rate reform.
- Require FEMA to provide increased transparency to all stakeholders regarding its decision making process for developing and updating its flood maps and rate making.
- Encourage a coordinated effort between the public and private sector to increase overall take up rates of flood insurance, including facilitating opportunities to educate consumers about flood insurance policy options. Implement methods to ensure better compliance with the federal mandatory purchase requirement and encourage the purchase of flood insurance for those outside of special flood hazard areas.

I am confident we can work with members of Congress to encourage timely debate and reauthorization of the NFIP. To do anything less might needlessly stress our economy.

(Continued on page 12)

We cannot afford to have people locked out of home ownership for lack of flood insurance coverage.

Interest from the Private Sector in Writing Flood Coverage
Recently, there has been significant interest from the private sector in writing flood insurance coverage. Like many types of new coverages, private flood coverage is being developed and offered first by surplus lines insurers, which typically insure unique or otherwise difficult to underwrite risks the admitted market is, at least initially, reluctant to insure. While flood insurance is not new, it has not been written in the private sector since the 1960s. Thus, insurers lack the historical data on flood loses they rely on for pricing coverage.

Insurers are beginning to use data analytics to improve their knowledge of flood risk. Catastrophe modelers are now offering information on the flood peril not available in the past. Geo coding and mapping of flood risks allows insurers to better understand the risk at the property level. This understanding allows them to develop a price which in many cases will be competitive with the NFIP.

There is some interest from the admitted insurance market at this time and, there is a growing appetite in the surplus lines market to provide private flood insurance coverage equivalent to or broader than the offerings of NFIP. As the industry becomes more comfortable with the ability of the surplus lines insurers to write private flood insurance coverage profitably, the interest of admitted insurers may grow.

The NAIC developed a requirement for insurers to include a line item in their financial statements beginning in 2017 highlighting their private flood insurance activity. Collection of this data allows state insurance regulators to capture the entire spectrum of flood data to help determine the effect of catastrophic flood events on the U.S. insurance market and identify the percentage of policies sold through the private market versus those sold through the NFIP.

In order to better promote and facilitate the development of the private flood market, state insurance regulators believe changes must be made to address some of the unintended consequences resulting from the federal Biggert-Waters Flood Insurance Reform Act of 2012 (BW12). Although one of its objectives was to provide opportunities for the private market as an alternative to the NFIP, the definition of and regulatory environment surrounding private flood insurance created by BW12 conflicted with this objective making it more difficult for state insurance regulators to protect consumers and ensure availability of the product.

Specifically, BW12 empowers federal banking and housing regulators to potentially regulate the solvency of private flood insurance carriers. State insurance regulators have expressed their concern noting banking and housing regulators lack the expertise and experience to regulate insurers or insurance markets. Bank regulators have different regulatory objectives than insurance consumer protection. Another impediment for entrants into the market is the vague definition of private flood insurance included in BW12.

The NAIC supports the Flood Insurance Market Parity and Modernization Act (H.R. 1422/S. 563) which clarifies state insurance regulators have the same authority and discretion to regulate private flood insurance as they have to regulate other similar insurance products and markets. This legislation also alleviates state insurance regulators' concerns about the private flood definition in BW12 by defining private flood insurance as a policy issued by a licensed insurer or eligible surplus lines insurer and provides coverage compliant with state laws and regulations. These clarifications will assist in removing the restrictive language in current law to help prompt more insurers to enter this market if they are willing. Facilitating the entry of additional insurers into the market will provide consumers with access to additional options for flood insurance products.

Some have expressed concern about having surplus lines insurers writing private flood insurance coverage as regulation of surplus lines insurers is viewed as less rigorous. State insurance regulators oversee the surplus lines insurance marketplace by imposing capital and surplus requirements on eligible U.S.-based insurers and licensing and supervising surplus lines brokers. While the surplus lines market is regulated differently than the admitted market, state insurance regulators have significant authority to ensure consumers are well-protected.

Surplus lines insurers domiciled in a U.S. state are regulated by their state of domicile for financial solvency and market conduct. Surplus lines insurers domiciled outside the U.S. may apply for inclusion in the NAIC Quarterly Listing of Alien Insurers. The insurers listed there are subject to capital and surplus requirements, a requirement to maintain U.S. trust accounts, and character, trustworthiness and integrity requirements.

Importantly, the insurance regulator of the state where the policyholder resides also has authority over the placement of the insurance by a surplus lines broker and enforces the requirements relating to eligibility of the surplus lines insurer to write policies in that state. In the event a policyholder is the victim of misconduct by the broker, the insurance regulator can sanction the broker or revoke their license. If there is a problem with coverage and a claim being paid, whether resulting from acts of the broker or insurer, the

(Continued on page 13)

insurance regulator can ultimately hold the broker liable for the full amount of the policy. This regime provides strong incentives for surplus lines brokers to not only comply with applicable laws themselves but also to sell policies from surplus lines insurers a strong financial condition and in good standing.

Most state insurance regulators can also use their authority under the state Unfair Trade Practices Act and similar statutes to ensure consumers are protected. These laws assure valid claims are paid; the insurer or broker is not misrepresenting what is in the policy; as well as remedying other forms of bad conduct. As the private flood market develops, state insurance regulators remain committed to effective regulation and to making changes to their regulatory structure when necessary.

As insurance markets evolve, state insurance regulators remain fully engaged with all relevant stakeholders to promote competitive and diverse markets and an an optimal regulatory framework—private flood insurance is no exception. State insurance regulators believe well-regulated markets result in well-protected policyholders and will meet any new challenges posed by a dynamic private flood insurance market.

◆ Infrastructure Investments

Insurers have access to substantial amounts of capital. As stated earlier, U.S. life insurers have more than $3.7 trillion in invested assets. Overall, U.S. insurers approach $8 trillion in assets to invest.

One challenge for the modern world is how to invest profitably and maximize rate of return while minimizing risk. Our lengthy stay in a low-interest-rate environment has not helped. Insurers, particularly life insurers, are interested in infrastructure investments, because they find them attractive for asset-matching purposes as they are of long-duration, offer stable and secure cash flows, and would allow insurers another form of risk diversification. Yet, current regulatory treatment does not encourage insurers to invest in infrastructure projects.

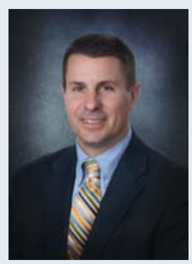
Investing in infrastructure is consistent with the Trump administration’s goal of modernizing our nation’s infrastructure. President Trump’s recent statements suggest spending $1 trillion on infrastructure projects. The spending would potentially stimulate economic growth and add jobs.

Why not explore whether insurers might provide some of the capital needed to support these infrastructure projects? In 2017, state insurance regulators will discuss whether insurers should be investing in infrastructure projects. On the surface, it seems like a beneficial approach. While there might be liquidity challenges with long-term investments of this nature, life insurers can asset-match and are most interested in the stable, secure cash flows and attractive risk-adjusted returns offered by infrastructure projects.

◆ Conclusion

The length of this article should tell you we have much work ahead of us. I am both humbled and pleased to be given the opportunity to lead. I am confident state insurance regulators and the industry we regulate are up to the many tasks before us. I look forward to working closely with my regulatory colleagues, consumers and industry representatives. Together we can move mountains—or at least chip away at some of the rough edges outlined in this article. I look forward to working with you all.

About the Author



Governor Scott Walker appointed Ted Nickel as Commissioner of Insurance for the state of Wisconsin on Jan. 3, 2011. The Office of the Commissioner of Insurance regulates the business of insurance in Wisconsin. The office has a staff of 153 and is responsible for examining industry financial solvency and market conduct, licensing agents, reviewing policy forms for compliance with state legislation, investigating consumer complaints and providing consumer information. In addition to its regulatory duties, the office administers the State Life Insurance Fund, the Local Government Property Insurance Fund, and the Injured Patients and Families Compensation Fund.

Nickel became president of the NAIC in January 2017. He currently serves on the Executive (EX) Committee, Cybersecurity (EX) Task Force, Government Relations (EX) Leadership Council, International Insurance Relations (EX) Leadership Group and Internal Administration (EX1) Subcommittee. He is a member of the NAIC American Indian and Alaska Native Liaison Committee and serves on several other NAIC task forces and committees. In addition, he chairs the Mortgage Guaranty Insurance (E) Working Group. Nickel is also a member of the International Association of Insurance Supervisors (IAIS). He is a member of the Executive Committee, as well as the Audit and Risk Committee. Additionally, he chairs the Site Selection Committee.

In August 2014, Nickel was appointed to the Federal Advisory Committee on Insurance, which serves as an advisory committee to the Federal Insurance Office (FIO).

Nickel earned his bachelor's degree in business administration with a concentration in finance from Valparaiso University.

NAIC Central Office
Center for Insurance Policy and Research
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Phone: 816-842-3600
Fax: 816-783-8175

http://www.naic.org http://cipr.naic.org

To subscribe to the CIPR mailing list, please email CIPRNEWS@NAIC.org or SHALL@NAIC.ORG

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. For more information, visit www.naic.org.