Key regulatory challenges

Facing the insurance industry in 2017

Americas FS Regulatory Center of Excellence

Along with other financial institutions, insurers face increasing regulatory risks and challenges in 2017. Regulators around the world continue their efforts to develop comparable frameworks across multiple jurisdictions for insurance conduct and supervision, while insurers themselves are working to implement a risk-based structure.

Overall, there are several key themes that have emerged in this changing regulatory environment. Regulatory reporting and a focus on consumer-oriented governance are driving the insurance industry regulatory challenges. Cyber-attacks are frequently targeted at insurers, jeopardizing highly confidential personal data. And, InsurTech, evolved from FinTech, is introducing innovative approaches to using technology in marketing insurance products to consumers while developing new underwriting, claims, and distribution platforms.

As insurance regulatory risk increases, management must demonstrate robust oversight, compliance, and risk management standards in an increasingly complex environment. In the U.S., anticipation regarding changes to insurance regulation at the Federal level, including the Financial Stability Oversight Council (FSOC) and the Federal Insurance Office (FIO), is creating some uncertainty. The House Financial Services Committee is expected to introduce a revised version of the Financial CHOICE Act[1], to roll back provisions of the Dodd-Frank Act including the FSOC's power to designate firms as systemically important financial institutions (SIFIs) and to eliminate the FIO. In early January 2017, the National Association of Insurance Commissioners (NAIC) expressed support for eliminating the FIO and the FIO Director resigned, providing opportunity for the new administration to appoint someone favorable to its agenda.

Overall the industry anticipates that 2017 will bring an easing of regulatory burdens and requirements at both the federal and state levels, reflecting support for the state-based system of insurance regulation and a progressive regulatory view for new market entrants, paving the way for innovation. The following are some of the key regulatory issues expected to impact the insurance industry in 2017.

1 H.R. 5983, The Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs) Act of 2016, was first introduced on September 9, 2016 http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf

1. Achieving equivalence and covered agreements

In January 2017, the United States Trade Representative (USTR) and U.S Department of the Treasury (Treasury) reached an agreement with negotiators from the European Union (EU) on a covered agreement that provides U.S. insurers with a level playing field in the EU. The agreement covers three areas of prudential supervision: reinsurance, group supervision, and confidentiality.

The covered agreement mutually recognizes the U.S. and EU supervisory frameworks. U.S. insurers will continue to be supervised according to U.S. standards. They will not be subject to the EU's Solvency II group capital, reporting, or governance requirements or be required to post collateral on business written in the EU. In return, the EU insurance industry receives reciprocal treatment in the United States. The arrangement goes further toward reducing collateral requirements in the U.S. that are based on reinsurance collateral reform adopted by state regulators. EU reinsurers in the U.S. may no longer have to post collateral, therefore releasing large amounts of tied up funds. Reinsurers in both jurisdictions must meet financial strength and market conduct requirements to benefit from the covered agreement. Information on the details of these requirements is pending.

Insurers now have more certainty and can move forward with long-term planning that was previously on hold. Removing market restrictions and the costs of duplicative regulatory requirements, along with a more efficient use of capital, should provide greater opportunities for insurers and presumably more choices for consumers. This is a significant step in mutual cooperation and recognition among insurance supervisors that may further emerge in the development of a group capital calculation in the United States and the global Insurance Capital Standard (ICS).

The NAIC remains opposed to the covered agreement based on the position that the agreement was negotiated at the federal level and without the direct involvement of state regulators or industry participants and without taking into account the possible preemption of state laws that may harm consumer protections. Testimony provided before the U.S. House Subcommittee on Housing and Insurance in February 2017 highlighted the NAIC's objections as well as support for the agreement from the former FIO director and varying positions from insurance industry trade groups.

Key points on implementation of the covered agreement:

- In the U.S., the agreement is subject to a 90-calendar-day layover period where Congress has the opportunity to review it, conduct hearings, and make recommendations. The agreement does not require Congressional approval and the FIO and USTR may bring it into effect after the 90-calendar-day Congressional layover, which began on January 13, 2017;
- U.S. and EU reinsurers must meet financial strength, market conduct and reporting requirements as established by the covered agreement to benefit from collateral reform and market access;
- States have 60 months from the signature of the agreement to adopt collateral reforms that meet certain prudential levels of consumer protection already in place in the United States at the state level. Additionally, 42 months after signature, the FIO begins the process of potential preemption of state laws inconsistent with the covered agreement;
- The EU will apply group supervision as outlined in the covered agreement in advance of internal EU approvals that are estimated to take three months.

2. Challenges from innovators and new market entrants

Financial technology, or FinTech, emerged in 2016 as a significant market force to challenge the financial services industry and its regulatory structure. InsurTech is evolving from FinTech and is focused on introducing innovative ways insurance products are sold to consumers using technology as well as developing new underwriting, claims, and distribution platforms. These insurance start-ups have a strong focus on the customer experience, as consumers demand more personalized interaction and products designed for an individualized risk profile. New FinTech-driven insurance players could potentially disrupt the marketplace unless established insurers and new entrants work together.

State insurance departments have a long history of conservative supervision dictating business conduct and financial reporting processes. To enter the marketplace, new entrants, including InsurTech firms, may be expected to meet certain qualifications, such as state admission and licensing requirements, minimum capital requirements, and ongoing financial strength to pay future claims. New insurers must pay attention to regulatory compliance to the same degree as traditional insurers.

Collaboration between insurers, emerging InsurTech companies, and state regulators is expected to increase in 2017 to enable innovation, address regulatory concerns, and ensure customer protection.

The emergence of InsurTech presents an opportunity to create consumer-personalized ratings, variable premiums, and incentives for good behavior. In addition, InsurTech presents opportunities to enhance the underwriting and claims process along with back office operations. In the near term, the focus is on improving customer relationships, largely driven by the millennial generation and the use of smartphone technologies. In the long-term, continued funding from various investment sources is expected to be aimed at improving a wide range of insurance activities and bringing new products and platforms to the insurance marketplace.

Traditional insurers would benefit from partnering with InsurTech companies, combining their insurance industry knowledge and customer base with new, innovative approaches to increasing customer touch points and creating a source of consistent renewals. Traditional firms should consider investing in InsurTech technologies to streamline business processes and introduce InsurTech into business plan models.

3. Expanding use of Big Data – benefits, risks, and challenges

The term Big Data refers to large amounts of data that can be analyzed and evaluated to determine trends and consumer behaviors and patterns. The amount of consumer data being collected has grown exponentially in recent years, driven by access to huge amounts of consumer information, largely through the use of mobile devices, websites, and social media. Traditional means of analysis cannot evaluate the information efficiently though insurers can still use Big Data analysis in a variety of ways: enhance the customer experience, improve underwriting and pricing, create greater efficiencies in the claims process, identify new marketing opportunities, and streamline back office operations. Recognizing the benefits of Big Data, regulators' concerns in this area primarily focus on protecting consumer privacy.

Insurers can benefit from new sources of data and analytics by using better information in risk taking and underwriting opportunities, identifying new customers, giving increased attention to the expectations of the millennial generation, helping to prevent fraud and identifying areas of significant claims activity. Reduced costs are achievable with more efficient back-office operations. While all lines of insurance can utilize Big Data predictive analytics, the property casualty sector is the first to realize the benefits through usage-based underwriting for automobile polices. Similar opportunities are developing in the commercial, life and healthcare areas. Overall, insurers require the right talent and tools to collect and analyze the massive amounts of data.

The use of Big Data does not occur without risks, both directly to insurers and involving legal and regulatory matters. Significant risks should be managed in three key areas: 1) consumer privacy; 2) security of customer data; and 3) appropriate use and conclusions. Managing these risks along with the right application of the data can drive an opportunity for competitive advantage.

In 2016, the NAIC created a Big Data Working Group to monitor developments in the area and "to gather information to assist state insurance regulators in obtaining a clear understanding of what data is collected, how it is collected and how it is used by insurers and third parties in the context of marketing, rating, underwriting and claims." Going forward, insurers should assess the potential of Big Data alongside the privacy, legal, and reputational risks of collecting it and prioritize it in their risk assessment process. Insurers exploring the use of "RegTech" solutions can utilize machine learning and intelligent algorithms to make sense of the volume and complexity of Big Data and structure it to better identify current and emerging risks, predict compliance failures, and enhance business line coordination.

4. Increased emphasis on corporate governance

The NAIC adopted the Corporate Governance Annual Disclosure Model Act (CGAD) in November 2014, which requires insurers to annually submit detailed disclosures to lead state insurance regulators regarding their corporate governance structure, including policies and practices. Initial reporting was due June 2016, pending individual state adoption. The intent of the CGAD is to establish uniform state regulatory disclosures and assessments across the United States. The governance structure requirements are designed to support the Board of Directors (Board) and key executives to act in good faith and in the best interests of consumers and the company.

By year-end 2016, a small number of states had adopted the CGAD and others were moving the legislation forward. During 2017, insurers may experience pressure to put in place governance and control frameworks that specifically recognize and protect the interests of policyholders even in states that have yet to adopt the CGAD.

The disclosures required under the CGAD describe the insurer's "corporate governance framework and structure," including:

- Description of the Board and its committees, duties, size, governing documents, charter or by-laws;
- Qualifications and experience of board members;
- Election process for the Board;
- Self-evaluation of the Board's performance; and
- Process for determining compensation and performance reviews, including clawback provisions.

Most importantly, information on the Board's committees and senior management's consideration of all critical risk areas that impact the insurer's business must also be disclosed. As additional states adopt the NAIC model, U.S. insurers must be prepared to provide a more comprehensive, detailed disclosure of corporate governance procedures and confidential information than ever before.

At the international level, the International Association of Insurance Supervisors (IAIS) currently has four Insurance Core Principles (ICP's) dedicated to corporate governance. The focus of these ICPs include overall corporate governance, suitability of officers and key persons, risk management and internal controls, and public disclosure. IAIS members, inclusive of the U.S., are expected to implement these requirements into their supervisory frameworks and will be evaluated regularly against those expectations of ICP compliance.

Recovery and Resolution Plans (RRPs) are also a key focus of the IAIS ICP covering global systemically important insurers (G-SIIs). All insurers should closely monitor regulatory expectations in this regard, however, as there is potential for the requirement to be extended to a larger subset of entities or domestic systemically important insurers (DSIIs). Key features of the RRPs include defining the connection with the risk management function, detailing recovery options and describing the governance framework. Demonstrating Board and senior management involvement in the RRP is a key part of gaining supervisory approval for a corporate governance framework.

Insurers and reinsurers should consider the following keys features of a resolution plan:

- Group and legal entity information – description of the legal entity structure and financial and operational dependencies;
- Critical functions – identify and plan for continuance of critical functions and critical shared services inclusive of financial, legal and operational functions;
- Business lines and market stability – consumer and market impact of closure or substitution of core business lines;
- Potential barriers to resolution – developing a feasible plan making effective use of regulatory resolution authority considering costs, risks and implementation.

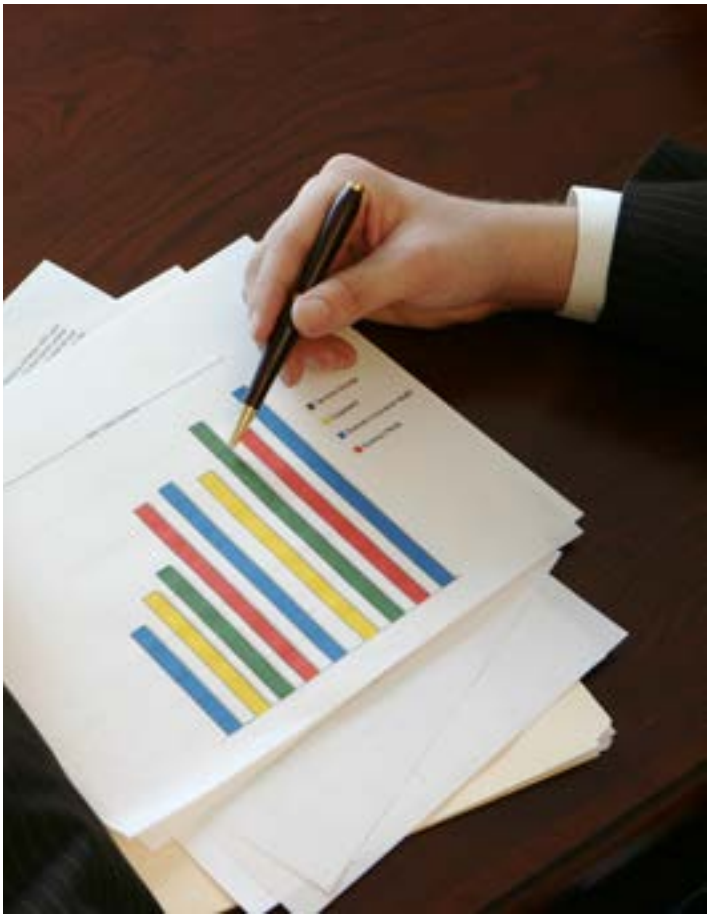
5. Ongoing development of capital frameworks

The NAIC continues progress on a group capital calculation based on a Risk Based Capital (RBC) aggregation approach. The calculation is intended to provide regulators with more and better information on risks the group structure may impose on the individual legal insurance entities. However, the scope of the group has yet to be decided. At issue is the appropriate capital for non-insurance entities not subject to a capital charge, non-insurance affiliates with other sector capital charges such as banks, legal entity insurers not subject to RBC, and non-U.S. insurers. For the non-U.S. insurers, two approaches are contemplated. One approach would be to determine a factor based on local target capital similar to a U.S. company's RBC action level. The other approach would be based on a premise that an insurer with a stronger non-U.S. capital ratio should receive a lower capital charge. The NAIC plans to field test the group capital calculation in 2017 and 2018 with a tentative implementation in 2020 based on 2019 data.

The Federal Reserve Board (Federal Reserve) continues to consider proposals for a dual capital framework for insurers that separately addresses insurers designated as SIFIs by the FSOC and insurers that own a depository institution. However, these proposals may be affected by the reintroduction of the Financial CHOICE Act in 2017, which is expected to contain provisions to eliminate the non-bank SIFI designation. Insurers remaining under the Federal Reserve's capital framework could be subject to enhanced reporting to the Federal Reserve and capital aggregation. Insurers subject to the Federal Reserve should evaluate their exposure to differing capital requirements and also consider whether their current corporate structure is the best approach with an aggregation of regulatory capital.

The Federal Reserve has made clear that capital approaches developed overseas are not currently aligned to the U.S. domestic insurance market. However, the agency expressed support for certain standards being developed in the European Union that support the non-U.S. approach. These included limited recognition of capital in other jurisdictions or financial sectors and reliance on stress and scenario testing to achieve international consistency and measurement.

At the international level, the IAIS is moving forward with an ICS for internationally active insurance groups (IAIGs) along with a basic capital requirement (BCR) and a higher loss absorbency (HLA) for G-SIIs. The IAIS reconfirmed its aim of converging global regulatory capital standards and continues to move towards a market-based valuation for assets and liabilities as a basis for group capital and solvency assessments. Market-based valuations are not generally supported or adaptable to the U.S. regulatory system, which creates a hurdle to finding common ground for agreements between international and U.S. regulators regarding insurance reporting.



6. Regulatory reporting reform

Globally, insurers and regulators are challenged with the integration of the Common Framework for Supervision of Internationally Active Insurers (ComFrame), inclusive of the ICS, into local entity requirements as it moves through the legislative process in individual jurisdictions. While the ICP's developed by the IAIS apply to all insurance entities, ComFrame will apply to only IAIGs facilitating regulatory cooperation among home and host supervisors. The IAIS estimates approximately 50 insurance groups will be subject to ComFrame though no detailed list has been published. To be considered an IAIG, an insurance group must meet the following:

- One large insurer in the group;
- Premiums written in at least three jurisdictions with a minimum of 10 percent gross written premium outside the home jurisdiction; and
- Gross written premium of at least $10 billion or total assets of at least $50 billion based on a rolling three-year average.

The ComFrame framework assists supervisors in understanding group wide activities and risks and coordinating multijurisdictional efforts. Field testing of ComFrame is underway to assess the requirements and consequences of implementation, while allowing sufficient time for modification prior to adoption by the IAIS. Issues the IAIS must review in the current phase of field testing include capital resources, market adjusted valuation, and GAAP-adjusted valuations. The continuing work on ComFrame is expected to yield an ICS version 1.0 for confidential reporting during 2017. The IAIS is currently scheduled to formally adopt a version of ComFrame, inclusive of the ICS, for public reporting in 2019, with member implementation to follow. Though initially a global development affecting only large multinational insurers, the influence of ComFrame on local domestic insurers is inevitable. In the U.S., all insurers should prepare for regulators to increasingly take a group-wide focus and capital requirements to be determined with a greater emphasis on financial stability considerations.

7. Cybersecurity and consumer data privacy

The financial services sector, inclusive of the insurance industry, has serious concerns about cybersecurity and data privacy issues. The industry is responding to potential risks on related tracks: 1) protecting their own data and customer privacy, and 2) providing cyber protection to customers. Their efforts are focused on finding meaningful and cost effective ways to encourage policyholder best practices, such as firm wide security policies, employee awareness, and customer knowledge.

Citing incidents at insurers and third-party service providers, U.S. state insurance regulators suggest that no other industry is under attack from breaches to the extent occurring in the insurance industry. At the same time, insurance companies are acquiring significantly greater amounts of personal, identifiable data from clients. In further enhancing cybersecurity, a third version of the NAIC Insurance Data Security Model Law (IDS Law) is currently being drafted jointly by state regulators and industry participants.

Standards would be established for insurers on data security and data breach notification and investigation, and would apply to all entities licensed by a state regulator. Attention is primarily being directed toward regulatory uniformity, harm triggers defining a data breach, the definition of personal information, the appropriateness of an exemption if an entity is subject to the Health Insurance Portability and Accountability Act of 1996 (HIPAA), security requirements for smaller licensees, and oversight of third-party service providers. Any regulation eventually adopted will require licensed entities to ensure that third parties also have appropriate safeguards to protect information in their possession and the licensee is responsible for any third party failure to protect such information. As the drafting of the IDS Law continues towards a final version, insurers should, in preparation, consider documenting now:

- Data flows through the organization;
- Transfer of data to third parties and the subsequent sharing of data to other service providers;
- Current cybersecurity requirements for third parties;
- Data protection, response, and customer notification procedures; and
- Compliance with current regulations and differences from the IDS Law.
- The state of New York has separately announced new cybersecurity regulations applicable to certain financial services companies regulated by the New York Department of Financial Services (NYDFS), which include insurance and certain reinsurance companies. This regulation is effective March 2017 and casts a wide net of requirements over any company authorized to operate in New York. The New York regulation presents the most comprehensive regulatory requirement for cybersecurity standards currently in effect. It is also more comprehensive than the draft NAIC IDS Model Law, particularly with regard to breach notification, requiring notifications to be made within 72 hours of determining that a breach occurred. In addition the NYDFS cybersecurity regulation requires covered firms to:
- Have a written cybersecurity program and a chief information security officer;
- Conduct annual certification by senior executives (or possibly by the entire Board) to the NYDFS Superintendent of compliance with the cybersecurity regulation;
- Perform penetration testing, vulnerability assessments, and risk assessments, as well as document audit trails;
- Maintain policies and procedures regarding application security, limitations on data retention, and nonpublic information accessible to or held by third-party service providers;
- Establish a written incident response plan and notification to the superintendent in the event of a cybersecurity event; and
- Conduct regular cybersecurity training for all personnel, with updated to reflect new risks as they emerge.

At the Federal level, the Trump Administration plans to review all U.S. cyber defenses and vulnerabilities, including critical infrastructures. Their stated plan is to make cybersecurity a priority in both the government and private sector. Insurance companies should closely monitor Congressional activity regarding cybersecurity and voice concerns over potential conflicts that may develop between federal and state initiatives.

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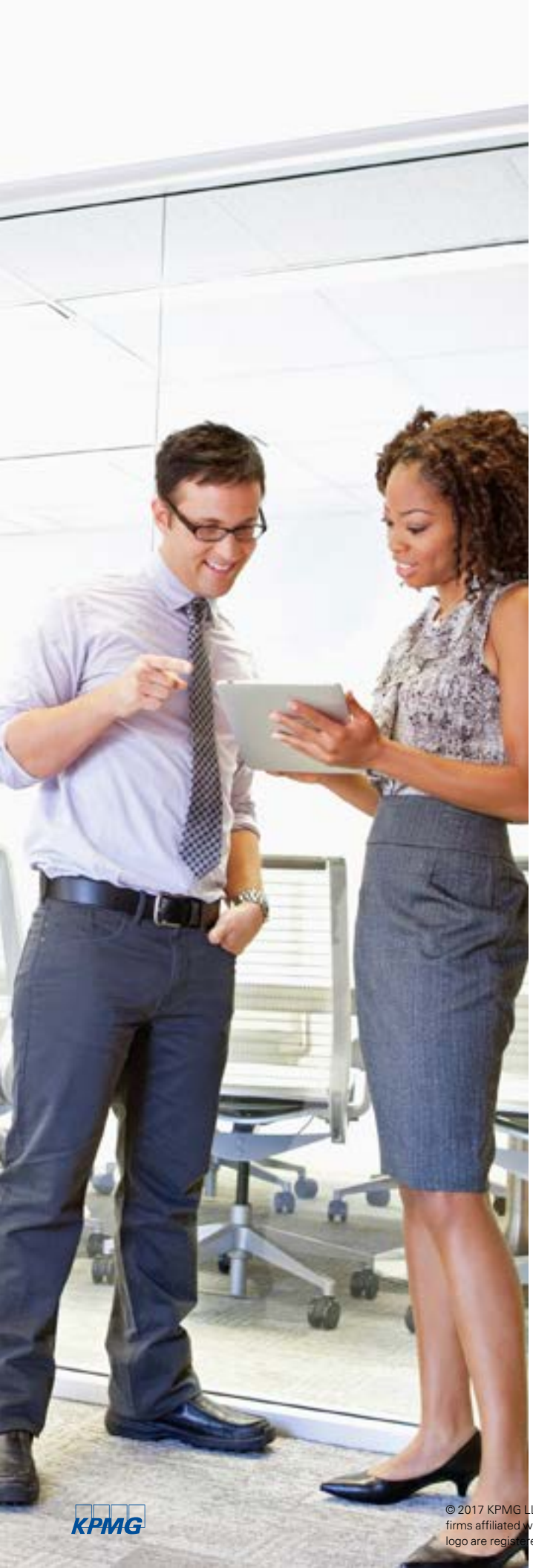
Beyond the challenges the insurance industry faces, market opportunities are rapidly expanding for insurers to provide cyber insurance protection, both through stand-alone and package policies, as the customer demand for protection increases. Significant pricing challenges exist, however, as underwriters have less data available for cyber risks than traditional forms of insurance. With limited actuarial data, qualitative solvency risk management information must be used to limit exposure. Insurers can also issue cybersecurity polices on a claims-made basis instead of occurrence to limit the time period for reporting claims, and create customized policies dictated by the size and scope of the business purchasing coverage. Over time, the amount and quality of data will increase, resulting in better pricing, increased accuracy of actuarial data to assess losses, and evolving policy terms to meet market demands. Time will tell if solvency issues develop either at individual insurers or across the system.



8. Principle Based Reserving implementation

Implementation of Principle Based Reserving (PBR) is ongoing, and a small number of insurers plan to value at least one product under PBR during 2017[2]. At year-end 2016, 46 states had adopted the revised model laws, representing 86 percent of the U.S. life insurance market. It bears watching how both Federal and state regulators consider PBR valuations as they determine appropriate capital requirements. Also, the Internal Revenue Service (IRS) has a PBR item on its current Priority Guidance Plan and is working to provide timely guidance regarding the impact of PBR on life insurance reserve computations under Internal Revenue Code Section 807. The objective of PBR is to determine reserves based more on the risks of the policies assumed by the insurer rather than a formulaic approach. Therefore the level of statutory reserves may be higher or lower for various products. Industry actuaries estimate there will be a slight decrease in overall reserve levels five years after implementation.

PBR is optional for a three-year transition period, but it becomes mandatory on January 1, 2020. Insurance companies should have already started their PBR compliance, irrespective of when they intend to adopt during the three-year transition period. As insurers move through the adoption process they should consider a multi-tier implementation program that permits parallel, integrated systems to be built to meet their implementation target. All life insurance companies should proactively conduct product and reserve reviews as part of a transition plan.

Life insurance companies subject to Federal Reserve supervision should approach PBR implementation with a heightened awareness of the link between reserves and regulatory capital. Insurers must decide to value products now using PBR or defer implementation for up to three years. They should closely follow the IRS rules for the tax effects from PBR and also have the proper systems and processes in place for the new valuation method.

2 Report of Society of Actuaries 2016 Mortality and Other Implications of PBR (VM-20) Survey – Part 2, Society of Actuaries, October 2016. Available at: https://www.soa.org/Research/Experience-Study/Bus-Practice-Surveys/2016-mortality-implications-pbr-survey-part2.aspx

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9. Repeal of the Affordable Care Act

Despite efforts to repeal and replace the Affordable Care Act (ACA) during the first months of the new Trump Administration, the efforts were not successful. It is anticipated the ACA will now remain in effect in its current form for the foreseeable future.

Notably, some news reports suggest the Administration may consider pursuing certain "administrative" adjustments to the ACA that could have an effect on the industry similar to the proposed legislation, such as implementing waivers of penalties imposed on individuals for not having health insurance, terminating certain insurer subsidies, and imposing new requirements for Medicaid enrollees. Funding cost sharing subsidies for low-income enrollees will need to be addressed. At present, federal programs to offset increased insurer healthcare costs expire in 2017. Some insurers, both large and small, may be forced to consider dropping out of the marketplace primarily due to actuarially unsound rates.

There is much uncertainty as to what will happen in the healthcare marketplace. Insurance companies will need to decide soon on their 2018 ACA participation. Above all, insurers should remain flexible in both short and long term planning as having a stable healthcare market in the U.S. will remain a concern. They should review products and services and consider new offerings. Insurers may also consider increasing cushions or reserves.

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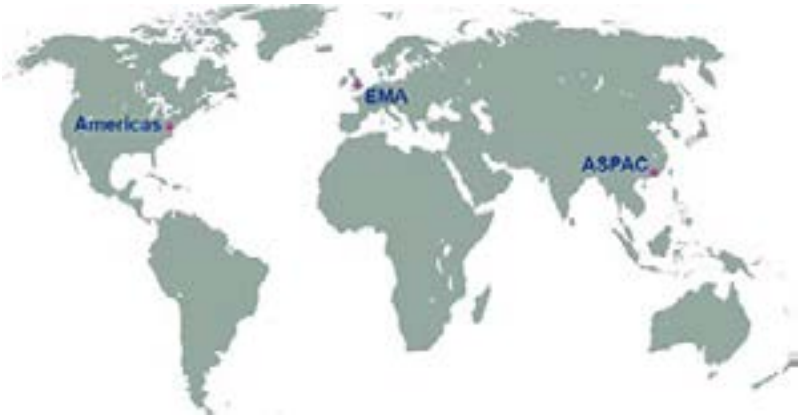

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