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Forward look

Top regulatory trends for 2015 in insurance

Produced by the Center for Regulatory Strategies

Foreword

This publication is part of the Deloitte Center for Regulatory Strategies' cross-industry series on the year's top regulatory trends. This annual series provides a forward look at some of the regulatory issues we anticipate will have a significant impact on the market and our clients' businesses in the upcoming year. For 2015, we provide our regulatory perspectives on the following industries and sectors: Banking, Securities, Insurance, Energy and Resources, and Life Sciences, and Healthcare.

The issues outlined in each of the six reports will serve as a starting point for the crucial dialogue surrounding the challenges and opportunities for the upcoming year and will assist executives in staying ahead of regulatory trends and requirements. We encourage you to share this whitepaper with the senior executive team at your company. In addition, please feel free to share your questions and feedback with us at centerregstrategies@deloitte.com.

Best regards,

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Introduction

The regulatory landscape for insurance will likely continue to be challenging and uncertain in 2015. As was the case in 2014, the insurance industry can expect to face new rules and modified requirements that could significantly affect how companies operate. Regulatory bodies in the US and abroad have been significantly expanding their compliance, oversight and enforcement activities in recent years, and this is a trend which is expected to accelerate and add to rule-making and overlapping of regulatory roles. To be effective in this shifting environment, insurers need to keep a close eye on potential changes and expected impacts so they don't find themselves blindsided and scrambling at the last minute to achieve compliance.

This report highlights several key regulatory trends for the insurance industry in 2015. Although some of these trends — if taken at face value — might only seem relevant for a subset of companies, in most cases there will likely be a ripple effect that affects most insurers.

Here are some key trends to watch in 2015.

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1. **Dual regulation at the state and federal level:** *Regulation of the insurance industry in the US primarily has been the business of the states since the mid-19th century, beginning with New Hampshire's appointment of the first state insurance commissioner in 1851. But now emerging is an evolving hybrid model of dual State and Federal Regulation.*

In the wake of the financial downturn, the Federal Government is expanding its role in regulating the insurance business. The Federal Insurance Office (FIO), which was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), has broad responsibility for monitoring the insurance industry, although technically speaking it does not have formal regulatory authority over insurance companies. The Federal Reserve (Fed) also has a growing role in insurance regulation, with official responsibility for overseeing insurance companies that operate banks or thrifts, as well as those designated as non-bank Systemically Important Financial Institutions (non-bank SIFIs) by the Financial Stability Oversight Counsel (FSOC). What's more, international bodies such as the Financial Stability Board (FSB) and International Monetary Fund (IMF) are seeking a central supervisory point for US insurance, which is the norm in most other countries.

The exact roles of state and federal regulators are still being debated and continue to evolve. For example, despite the FIO's lack of formal authority over insurers, FIO Director Michael T. McRaith has said there is no longer solely a state regulatory system for the insurance industry. At some point, things may converge into a clear and consistent set of requirements across both the state and federal levels; but for now insurance companies must learn to operate effectively in a regulatory environment where uncertainty and inconsistency are the norm.

One impact we are already seeing is an overall escalation in regulatory expectations, as agencies at different levels play off each other and informally push each other to higher levels of regulatory scrutiny and rigor. This natural dynamic is raising the bar, leading to higher demands on compliance organizations and driving trends for adopting more effective "three lines of defense" control models, improved governance, and information technology supporting risk management and compliance. Also, there is increasing focus on certain parts of the business that did not previously get as much attention from industry regulators, such as HR, Finance and IT organizations.

To keep up, insurers need to examine their existing tools, processes, and infrastructure to ensure they are robust and flexible enough to comply with the new and emerging requirements. In many cases, addressing the issues will require significant improvements to compliance programs and capabilities. Also, as insurers scrutinize their product portfolios, some are choosing to modify or eliminate products or legal entities that might not be viable or profitable in a dual regulatory environment. Last but not least, industry leaders might want to help shape how the balance of power shakes out between the state and federal levels by leveraging their government affairs organization and their trade organizations to ensure that their voice is heard in the debate.

2. Convergence of US and international regulatory principles:
The US insurance industry faces increasing pressure to follow international regulatory standards.

International standards for insurance regulation have been evolving for two decades and are now being adopted by more than 120 countries. The International Association of Insurance Supervisors (IAIS) is pushing to make its regulatory framework a global reality and has recently seemed to become less receptive to new input from insurance companies and industry associations. The US, which is a founding member of the IAIS, is represented there by state regulators, the Fed and the FIO. However, as harmonized globally accepted insurance supervisory standards are agreed upon, state regulators are under growing pressure to conform with the way insurance is regulated in other parts of the world.

Global capital standards are being currently being field tested, and are expected to begin to go into effect in 2015 for G-SIIs, and in 2019 for insurers designated as Internationally Active Insurance Groups (IAIGs) under the Common Framework (ComFrame) for the Supervision of IAIGs. In the US, capital requirements for insurers have traditionally been legal entity-based and designed primarily to protect policy holders. However, the change in regulatory emphasis — particularly since 2008 — from micro-prudential to macro-prudential regulation represents a shift toward protecting the global financial system from economic shocks, as well as protecting policyholders' interests. The US has traditionally opposed that shift, and the related shift to group capital standards. However the National Association of Insurance Commissioners (NAIC), working with the FIO and the Fed, recently unveiled two possible approaches in its framework for a US group capital standard, acknowledging such a standard will become a reality despite the historical American opposition. Large, more complex entities such as G-SIIs and IAIG are likely to first feel the immediate impact of these changes, but it's likely that most insurance companies operating in the US will eventually be affected in one way or another.

Direct impacts include enhanced supervision, a need to hold high quality capital, new financial reporting requirements, recovery and resolution planning, risk management and corporate governance expectations. Indirect impacts could include new procedures during the supervisor's examination activities, or more in-depth scrutiny due to adjustments within the supervisor's prioritization scheme. In addition, regulatory modernization efforts will likely require greater diligence and expectations of directors and senior management and drive change in the US regulatory environment.

Companies facing designation as G-SIIs or IAIGs need to carefully identify the potential impacts — particularly how increased capital requirements could affect the business model and product portfolio. In some cases, existing products and services might need to eliminated or re-priced to be economically viable. They may wish to review existing processes against the new requirements and consider areas for enhancement.

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3. Own Risk and Solvency Assessment (ORSA):
The ORSA model developed by the NAIC goes into effect in 2015. ORSA will evolve over the next several years as regulators receive initial filings and provide feedback to industry. Now is the time for action.

Under ORSA, certain US insurers and insurance groups are required to subject themselves — at least once a year — to a confidential internal assessment of:

- Material and relevant risks (as identified by the insurer) associated with its current business plan
- Sufficiency of capital resources to support those risks

Beginning on January 1, 2015, affected companies must submit their initial summary findings within the year; however, regulators are strongly encouraging organizations to get in touch early for an informal discussion so there are no surprises about the agreed ORSA reporting expectations.

Although some insurance companies and groups are not subject to the ORSA requirement, all insurers in the US can expect a new regulatory paradigm in which insurance supervisors place greater emphasis on reviewing enterprise risk management (ERM) frameworks and gaining a group-level perspective on risk and capital. While most ERM frameworks continuously evolve based on their nature, scale and complexity, insurers and insurance groups can get ahead of the curve by conducting their own readiness assessment and pro-actively addressing any weaknesses in their ERM frameworks and group capital assessments.

4. Corporate governance:
In 2014, the NAIC approved a framework for corporate governance, which requires the annual collection of information about an insurer's corporate governance practices.

The framework, which is now being considered by the states for adoption, would require every insurer to file an annual report about its corporate governance practices, including its governance framework, management policies and practices, and the policies and practices of its board of directors and committees.

States may use the framework as a foundation, layering on additional requirements as they see fit. During this process, privacy issues are likely to be at the center of the debate. While most companies seem satisfied with the disclosure protections established in the NAIC framework, including protection from subpoenas and freedom of information laws, there is an underlying concern voiced by some that those protections may not be sustained. In situations where individual states try to reduce those protections, insurance companies might push back.

Other high impact areas are likely to include suitability tests for board members; closer scrutiny of executive compensation plans and structures; and a deeper understanding of where and how risk is managed at the board level. A key question is what level of board approval is required for risk-related issues, such as the organization's risk appetite statement.

Many major insurance companies are already used to this kind of intense scrutiny. Small- and medium-size companies may need to make significant investments in order to comply with the new requirements. At a minimum, the Corporate Model Governance Act will require an internal audit function with a direct line of communication to the board. The good news is that the push for better governance can be a real opportunity to fundamentally improve how the company makes decisions and manages risk. It doesn't have to be just a check-the-box exercise.

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5. Use of captives:
The debate rages on over how to prevent insurers from using affiliated captives in ways that might enable them to evade accounting rules and reserve requirements.

Not much has changed in this area since last year. While regulators in New York and California remain opposed, the NAIC recently accepted the recommendations of its consultant in the modified Rector Report. Some opponents at the NAIC expressed continued concerns about reserves and nontransparent risks. However, supporters argued that the use of affiliated captives to address the gap between statutory and economic reserves benefits consumers by allowing insurers to price products in a reasonable way that reflects actual risk.

Note that the recommendations for captives in the Rector Report are prospective — affiliated captives that already exist are unaffected. Also, some uncertainty remains. The FIO, which identified use of captives as a gap in state regulation, has not weighed in since the modified Rector Report was adopted. However in its annual report to Congress on systemic risks, the Office of Financial Research (OFR), the office within Treasury tasked with providing research support for FSOC, named this use of captives as among the major emerging systemic risks. In addition, details of the proposed framework are likely to evolve as technical questions are addressed.

Until they receive clear guidance from regulators, insurers should take the initiative to assess their own use of affiliated captives, asking questions such as: *Will we be able to manage our capital needs if reserve requirements are strengthened? Will we need to adjust our product mix? What should we be doing to monitor and manage possible reputational risk? And what are the benefits and disadvantages of captive restructuring?* Given that regulatory changes in this area are unlikely to apply retrospectively, there might be a window of opportunity for companies to review the efficiency of their current approach. Also, companies should keep a close eye on regulatory developments, and actively communicate their plans to regulators in order to avoid misunderstandings.

6. Principle-based reserving (PBR):
Uncertainty continues over the best way to determine reserve requirements for life insurance — with no resolution in sight.

Insurers argue that the traditional formula-based approach is outdated and produces reserve requirements that are excessively high. In their view, a principle-based approach is more reasonable and fair, especially now that companies have access to better systems and data that enable greater accuracy and personalization. The NAIC agrees, and has approved the shift to principle-based reserving. However, the change can't take effect without approval from a supermajority of states representing 75% of the life premium — and at the moment that goal is still in the distance. New York and California have already expressed strong opposition, with New York going so far as to say it would not accept PBR even if other states approve.

Principle-based reserving could enable companies to profitably offer a different mix of products. However, at this point, no one knows how the debate will play out. We might see a partial shift to PBR, even if key states such as New York and California hold on to the traditional approach.

Given the long lifecycle for insurance products, insurers should start to think about the potential impacts of PBR. That includes creating capital plans for a range of scenarios, as well as developing new life insurance products that could potentially capitalize on modified reserve requirements.

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7. Cyber security threats:
Insurance companies are an increasingly appealing target for hackers and cyber theft and need to shore up their cyber defenses before they are seriously compromised.

Customer data has become a valuable commodity for hackers and criminals, and insurance companies are loaded with it — making them a prime target for cyber attacks. Historically, insurers have been able to justify spending less time, money and effort on cyber defense than other companies do, in part because the insurance business involved fewer customer interactions and touch points than transaction-oriented businesses such as banking, investment management, credit card processing, and retail. But as insurers expand their footprint to mobile devices and the internet — and as the value of customer data continues to rise — it won't be long before the insurance industry is under assault. In fact, a large insurer recently found itself in the headlines after hackers had infiltrated its systems and stolen massive amounts of information — not only about the company's customers, but about anyone who had requested a policy quote. Having consumers afraid to contact an insurance company for quotes can't be good for business.

Insurance regulators have begun to recognize the serious and rising risks of cyber threats in the industry, and the fact that many insurers are unprepared. Recent sweeps uncovered significant vulnerabilities throughout the industry, including widespread use of antiquated legacy systems, as well as decades of underinvestment in IT and data security. These vulnerabilities could lead to cyber attacks that have a devastating reputational impact, not only for individual companies but for the insurance industry as a whole.

In response to this growing threat, regulators are starting to raise the bar on cyber security. As an example, the NAIC established a Cyber Security Task Force reporting to its Executive Committee at its November meeting.

To tackle the challenge effectively, companies may need to elevate the problem to the C-Suite and board level, and will likely need to increase their investments in IT and data security. Immediate action steps include assessing risks and vulnerabilities in the current IT environment (including those for independent agents and other third parties); improving coordination between the Compliance and IT/security functions; and reviewing and adjusting the resources allocated to cyber security issues. Of course, it's impossible to be 100% secure from all attacks. A goal a company can reasonably strive for is to be secure, vigilant and resilient — constantly protecting itself from the most serious threats, and creating the capabilities to minimize damage and bounce back quickly when an attack occurs. In particular, developing a robust crisis response and remediation strategy is a proactive measure many leading companies are putting into place.

8. Focus on annuities:
Regulators are continuing to scrutinize annuity products, which are growing by leaps and bounds in the marketplace.

Annuity products, such as index universal life policies, are becoming increasingly popular as consumers look for reliable, lifelong sources of future income. Also, annuities tend to be more complex than other insurance products, increasing the potential for misunderstandings and misrepresentation. In addition, there is a strong possibility that interest rates will remain historically low for the foreseeable future, which could make it difficult for insurance companies to deliver the anticipated payment streams without having to hit policyholders with unexpected cost of insurance premium increases. These factors are prompting regulators to increase their scrutiny of annuity products and how they are advertised, marketed and sold.

If regulators find a company or its agents are misleading consumers — by accident or on purpose — or making implied promises it may not be able to keep, the company could face significant fine, penalties and other remediation. Even more important, the company's reputation would likely take a big hit in the marketplace, which could be very harmful to a business fundamentally based on long-term trust.

To avoid problems, insurers need to closely examine their annuity products to minimize the risk of misunderstandings and misrepresentation. Disclosures and marketing materials need to be accurate and clear, and sales practices, including replacements, need to be suitable and appropriate. This might require improved training for independent agents and employees so they can better understand and clearly explain these complex products to the average consumer. To avoid a major industry crisis such as the life insurance abuses of the 1980s, insurers should take corrective action now, before regulators start clamping down.

Moving Forward

Change will continue to be a defining feature of insurance regulation in 2015. The Fed is staffing up and is soon expected to issue new rules governing SIFIs This is relevant both for existing SIFIs, for companies being considered for the designation, as well as applying Fed regulatory compliance standards to insurers who own thrifts. G-SIIs and IAIGs likely will begin to feel the impact of new global capital standards. Meanwhile, here at home, US groups can expect to face increasing pressure for more direct supervision at the holding company level.

As the NAIC's Solvency Modernization Initiative bears fruit, most US companies will be filing their first ORSAs in 2015 — even as they prepare for their first Corporate Governance Disclosure Statements in 2016. And, of course, there is always a chance for the unexpected, perhaps from the FIO, which has been relatively quiet in 2014.

Increases in both the scope and pace of regulatory change will continue to drive up the demand for experienced professionals for the risk and regulatory functions in the insurance business. A company wishing to position itself to cope effectively with these shifts may want to start by looking inwards, examining its current risk and regulatory functions and how they might be restructured to cope with the new regulatory paradigm. Such a transformation could help a company better anticipate the future, enabling it to nimbly and profitably adapt to changes that are still beyond the horizon.

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