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2023 insurance regulatory outlook

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Introduction

For 2023, notwithstanding ongoing macroeconomic risks fueled by inflationary pressures to financial stability, there will likely be no more encompassing and pressing issue for the insurance regulatory arena than climate change risk and mitigation. Preparation and application of climate risk work are expected to filter through every area of the insurance sector, driven by deep-reaching rules that are either now in place or primed for implementation.

Climate change risk has been prioritized in the United States as an urgent threat that needs to be addressed, and the insurance sector has a big part to play. The Financial Stability Oversight Council (FSOC) identified climate-related financial risk as an emerging threat to the financial stability of the United States and increasingly spotlighted the Biden administration's efforts to manage its effects and avert a climate disaster on both a market and a humanitarian basis.[1] Collective global efforts to reduce the most extreme of future climate impacts require emissions to decrease substantially in this decade.[2] Many leading insurance regulators are firming up their efforts and exploring ways to make sure coverage is available and affordable.

Consumers and regional property insurance markets could face instability, marked by high-priced or inadequate coverage. Managing transition risk while trying to keep underwriting in line with new rules and considerations will be at the forefront of operating in the insurance sector.[3]

In addition to climate-related risks, both emerging and long-standing regulatory issues remain and will also drive regulatory planning and action in the coming year, with everything from fact-finding discussions in the commissioners' office, to data calls, to proposed rules and the enforcement of new ones. And the new balance of power in Congress will mean that any legislation must be brokered by compromise and maintain a moderate track. Federal agency mandates on climate risk disclosures could be spotlighted as too onerous in future House hearings, as one side looks to curb what it sees as excessive rulemaking.[4]

Yet, weather-related deadly disasters that continue to impact large population centers might prompt more fruitful across-the-aisle discussions on addressing protection gaps for consumers and the role of the federal government as a backstop. Cybersecurity vulnerabilities and data privacy are also expected to get congressional attention as bipartisan concerns.

Against this backdrop, confronting the impact of climate change has taken on even more urgency as the US population wakes up to wildfire, flooding, or windstorm disasters on a more frequent basis.[5] The US agencies and regulators will likely be more primed to act in the wake of deadly and destructive Hurricane Ian, especially given warnings from the federal government predictive modeling that in the future, a higher proportion of the storms that form offshore will intensify to higher category hurricanes. Treasury Secretary Janet Yellen even issued a proposed data collection from insurers, especially in the homeowners insurance lines, to assess climate-related financial risk across the United States. The effort to grasp these vulnerabilities "will add to the work of regulators and policymakers across the administration to assess climate-related risks to the financial system," as well as the US economy and the population, she said.[6]

On the West Coast, wildfires threaten populated areas that they had not traditionally reached. These fast-spreading disasters are the peril that climate scientists have seen escalate more than any other. They are expected to be more frequent and more severe, according to experts. Consumers and regional property insurance markets could face instability, marked by high-priced or inadequate coverage. Managing transition risk while trying to keep underwriting in line with new rules and considerations will be at the forefront of operating in the insurance sector. Policymakers are closely monitoring the growing use of artificial intelligence (AI) for potential negative outcomes for large segments among disadvantaged groups due to potential biases that could be embedded in data inputs. For example, the National Association of Insurance Commissioners (NAIC), the organization that oversees state regulators, has resolved to address this through an anticipated lengthy process of identifying issues that could later involve course correcting at the company level.[7]

An active NAIC has begun to commit to timelines and deliverables, as underscored by the messages from lead state officials during the NAIC Fall 2022 conference. A more focused NAIC seeking to develop new guidance combined with active state rulemaking activities will characterize 2023. The insurance sector will also continue to see the expansion of cybersecurity disclosure requirements as technology advances, with regulators wanting to keep an eye on companies' resilience planning, their internal controls, and their cybersecurity training regimens. When so much is at stake for customers with their personally identifiable information (PII) discoverable through breaches, not only have companies' IT and compliance departments prioritized data privacy hygiene, but leadership also considers it a top priority.[8]

The Best Interest (BI) investment product sales standard for annuity and other life products is now part of the national oversight landscape. We expect an acceleration in enforcement as federal and even state regulators devote more resources to it after a fallow period of more gentle guidance than enforcement.[9] In fact, the head of the Financial Industry Regulatory Authority (FINRA) made it clear in November that companies need to make sure they comply with Reg BI because exams are underway, cases are in the enforcement "pipeline," and violations in suitability will violate the Reg BI standard as well, potentially resulting in dual violations.[10]

Our outlook provides a look into these and other key policy matters that are likely to emerge in the coming year so that insurance professionals are better prepared to operationalize new rules and regulations and anticipate emerging ones.

Managing transition risk while trying to keep underwriting in line with new rules and considerations will be at the forefront of operating in the insurance sector


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Climate change: Risk disclosure, scenario planning, and resiliency

With the Securities and Exchange Commission (SEC) consulting the industry on a new climate disclosure regime and the annual NAIC Climate Disclosure Survey refresh now in place, insurers are looking to meet the requirements of the Task Force on Climate-related Financial Disclosures (TCFD)-aligned disclosures adopted at the state level in states representing about 80% of the US market.[11]

Companies will likely need more guidance on these complex disclosures and requirements because the realities of climate risk go far beyond actual disclosures as catastrophic weather events threaten communities and reveal major inadequacies in the availability and affordability of coverage and perhaps reinsurance capacity. State regulators, via the NAIC, could keep pressure on insurers' risk and consumer interactions at a more granular level in 2023, spurred on by work from the Federal Insurance Office (FIO) to produce a report seeking to identify gaps in state-based climate-risk oversight.[12] The FIO intends to collect data from insurers to assess climate risk vulnerabilities to them and to the population, with the backing of Treasury Secretary Yellen, who said after Hurricane Ian's impact that the Treasury wants a better understanding of the insurance market's vulnerabilities to climate change. The NAIC's leadership has pushed back, arguing in a pointed letter that the FIO is not engaging state insurance regulators as it should and might instead erroneously capture a wide swath of data not tied to climate risk in its availability and affordability data collection review, such as that involving social and legal trends.

Meanwhile, concerned lawmakers have been hosting hearings on legislation impacting coverage issues and insurers' responses to mounting wildfires and other natural catastrophes.[13] Legislative inquiries into the effects of extreme weather on increasingly vulnerable consumers will likely find firm footing in 2023, so it is essential to be prepared to answer requests.

Climate change policy brings with it a host of new responsibilities, challenges, and opportunities for insurers as they adjust to new protocols, rules, and leading practices while facing the challenge of disorderly and late-transition risks, physical risks, legal risks, and disclosure deadlines within compliance frameworks.

One of the most pressing actions will likely be the fulfillment of climate disclosure requirements required by the states as well as the new framework of extensive disclosures to be instituted by the SEC. There may be legal challenges after finalization, especially in the wake of the June 2022 Supreme Court decision in *West Virginia v. Environmental Protection Agency*.[14] As the SEC rules also face a multiyear timeline for implementation, public companies would be wise to have a structure in place to meet them. Despite pushback, the SEC's climate rules might survive attempts to dislodge them as they are anchored in the 1933 Securities Act.[15]

Within the disclosure requirements are expectations for identifying the material impact of climate-related risks on everything from the business model and strategy to financial statements, in all time frames—short, medium, and long term. The SEC's rules have a buffer of a phase-in period with additional time for Scope 3 emissions disclosure, but it is not too early to be ready and test systems to make sure they capture the information regulators are seeking. Scope 3 refers to emissions from activities upstream and downstream of an organization tied to assets not owned or controlled by the organization but which it indirectly effects through its own operations.[16] These Scope 3 activities can span, potentially, the full reach of a company's value chain. Also, insurers will have an array of challenges assessing and reporting the impact of severe weather conditions and other climate-related events on their financial statements and the assumptions backing them as they try to compute transition risk at the same time. The goal is to make it clear to investors where the company is heading and how costs may impact strategy.

The SEC is also expecting those that have scenario analysis and transition plans already locked in place to augment their disclosures on these so investors can get a handle on a company's climate risk management.[17]

While insurers might be prepared to disclose their direct and indirect greenhouse gas emissions (GHG) as required, they might seek more resources and assistance to gauge Scope 3 emissions. While the SEC could be dialing back on Scope 3 proposed rules—at least for now—due to market pushback and concern about the ability of the rules to withstand judicial scrutiny, it is not too early to be ready and test systems to make sure they capture the information regulators are seeking.[18] The Biden administration remains dedicated to a thorough climate risk response, so this might be an incremental move.

Through the work of the NAIC, insurance regulators have aligned and updated their climate risk disclosure survey to the TCFD framework. 15 US jurisdictions representing nearly 80% of the US insurance industry are requiring the annual submission of the revised climate risk disclosure survey under the NAIC-adopted TCFD alignment disclosure protocol.[19] Some company representatives indicated that they still lacked processes for senior management or their board to be informed of, or to monitor, climate-related risk during a September 2022 NAIC-hosted workshop. California's insurance department hosts the survey submissions, which were due at the end of November for all insurers with direct premium amounts of $100 million or more in participating states.[20] In addition, financial services companies, including insurers, must track the Greenhouse Gas Protocol guidance.[21]

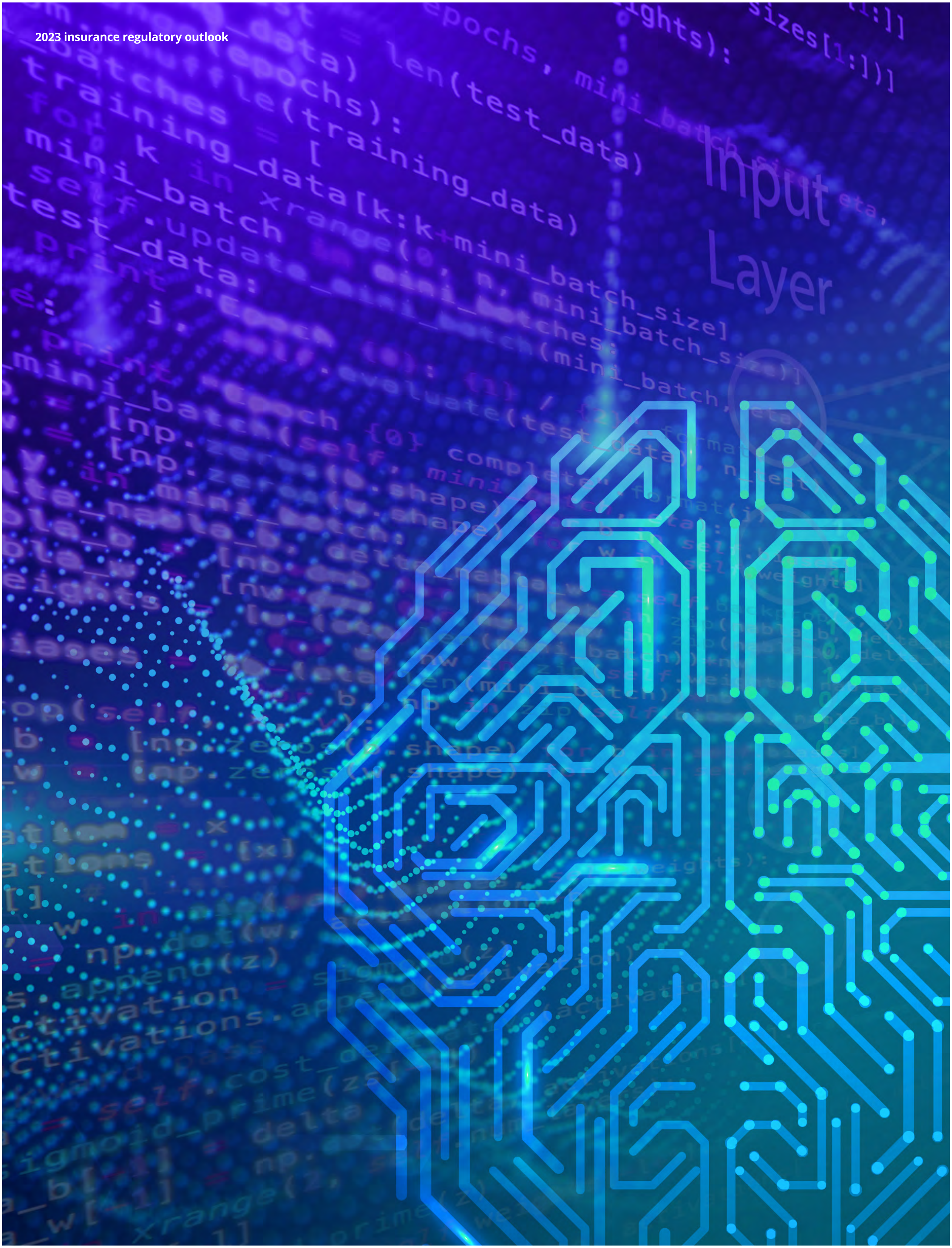
At the state level, Connecticut Insurance Commissioner Andrew N. Mais called for coordinated action to address the impact of climate change. "There is…action," said Mais, who recently joined the UN's Sustainable Insurance Forum (SIF).[22] Meanwhile, the California Department of Insurance (CDI) has made it its mission to improve outcomes by engaging at all levels of the sector on climate change risk.[23] It is aligning with global climate initiatives in reducing emissions; pushing for mitigation and resilience in hardscaping and infrastructure; closing protection gaps; and emphasizing affordability and availability,especially in vulnerable communities. The regulator of the largest insurance market in the United States introduced a first-of-its-kind sustainable insurance road map in November 2022, accompanied by a press release stating it expects the insurance sector to match the agency's "aggressiveness in protecting consumers."

The agency said it is poised to enforce protections against wildfires to give homeowners and businesses premium discounts as rewards for mitigating risk at their properties under a law effective in October 2022. California requires insurers to submit new rate filings that reflect the wildfire safety standards created by CDI. California will be enforcing adherence to insurers' timeliness and transparency, so insurers must have a process for their wildfire risk determinations, provide policyholders their property's "wildfire risk score," and support a right to appeal. This measure could potentially be adopted in other states where wildfires are a growing threat.

Internationally, there is growing consensus among supervisors that climate scenario analysis is an essential tool for assessing the effects of risks on the insurance sector and providing insight important to gauge financial stability. High-quality information requires a mandatory framework, as international insurance supervisors have suggested at global forums.

There will likely be an all-hands-on-deck approach among state, federal, and global supervisors to scrutinize the impacts of climate change on the financial stability of the industry and local markets while encouraging mitigation, availability, and affordability at the consumer level.

Insurers should familiarize themselves with new and developing guidelines while building out their internal systems to meet new and anticipated criteria. Transition plans need to not only be in place, but demand adherence and continuing input, including incorporating feedback from experts and regulators, as a disorderly transition has been identified as a risk for the insurance sector. They should position themselves to quickly share requested data with regulators and address further inquiries.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Artificial intelligence and machine learning (ML)

AI and ML have sharpened insurers' risk assessment tools, but care must be taken to avoid creating biased outcomes in both the selection and underwriting of policies. States are looking for ways to test for unbiased consumer outcomes and will look for ways to change laws and regulations based on what they find.[24] The Special Committee on Race and Insurance, formed in 2020 in the wake of a call to action on race and equality issues, is the nexus of multiple workstreams reviewing data at all levels of collection and deployment.[25] Regulators will be seeking more data and, in some jurisdictions, preparing to potentially test algorithmic models used to price or even reject coverage to see whether the outcomes affect protected groups to a greater degree.[26] Further highlighting the issues and underscoring the need for urgency, the White House issued a blueprint for an AI "Bill of Rights" in the fall. It contains a section on algorithmic discrimination protections.[27]

Over the past two years, NAIC committees have explored regulations governing innovation and inequities in insurance. The standard-setting organization is seeking information on what governance, risk management, and controls insurers are developing or are currently using to manage AI/ML. Now, they are coalescing into a more focused exploration of these issues. While new, outcomes-based regulation is still a bit far away—given that some jurisdictions such as the District of Columbia and Colorado are already moving with new or contemplated policies—regulation will likely first arrive on a state-by-state basis.[28] The House Financial Services Subcommittee on Diversity and Inclusion has also stepped in to question why the insurance industry lags behind the banking and asset management sectors in employing people of color as well as other metrics.[29] While fixing the situation might not happen swiftly, other efforts to improve the industry for underrepresented groups have gained momentum elsewhere, as well. Efforts are being led by select jurisdictions.[30]

The Special Committee on Race and Insurance and the Big Data/AI Working Group are trying to find ways to make sure protected populations and underserved groups do not get penalized or unfairly treated by algorithms using a multitude of data and factors. Regulators are increasingly working with outside vendors to monitor the use of AI throughout the underwriting and claims process, especially for property and casualty insurance. Identifying proxies for race based on historical or underlying data that itself might be biased presents a huge undertaking, and work is still in discussion in the Special Committee on Race and Insurance's five workstreams. The NAIC is coordinating with multiple internal groups to examine the effects on policyholders and others perhaps left uninsured by predictive modeling and the price and coverage algorithms that come from AI.

State regulators have shown determination to test for outcomes for bias and unfair discrimination as they pass and contemplate new laws.

The NAIC, at its fall meeting in December 2022, has announced plans to develop and adopt a framework of algorithmic accountability for the use of AI by the insurance industry to help prevent bias and unfair discrimination—a framework that had been discussed as a concept by stakeholders in previous meetings. The framework will take the form of a model interpretive bulletin and be principles-based with a focus on governance requirements and AI protocols, according to Maryland Insurance Commissioner Kathleen Birrane, who introduced the new initiative at a public meeting of the Innovation, Cybersecurity, and Technology Committee at the meeting. The measure won't seek to regulate third-party vendors at this time, Birrane said. However, she said that licensed insurers will bear responsibility for their use of these third-party outfits.[31]

On a state-by-state basis, the DC Department of Insurance, Securities and Banking is working with a data consultant to analyze the application process and the outcomes to see whether certain underwriting factors, such as credit scores, education, and homeownership, could cause harm to classes of DC consumers. This review, now in the beginning stages with an auto insurer data call prior to bias testing, could be followed by action from other state regulators who have asked for more information on this initiative.[32] If the DC Department of Insurance study, which was still undergoing an open comment period phase at the end of 2022, reveals unfair bias against current and potential (via rejection of coverage) insurance consumers in DC through carriers' use of AI algorithms, new legislation could be crafted to target insurers' algorithm use.[33]

Further, in the fall of 2022, insurers were heavily involved in stakeholder meetings with the Colorado insurance commission and the state insurance division on how the companies should test and demonstrate to state regulators. The Colorado law requires insurers to remediate any consumer harm if they have been found to have unfairly discriminated against consumers on the basis of a protected class. The law targets the use of external consumer data, information sources, algorithms, and predictive models that insurers use but will likely not be enforced until the Colorado Division of Insurance develops a plan with the industry's assistance.[34] The plan involves stakeholder meetings to identify, measure, and remediate bias introduced into the underwriting process by algorithms and the use of big data in delivering insurance products to consumers. The state insurance division has been hosting sessions with interested parties to address its implementation. The goal is to make sure AI and other forms of ML applications are not unfairly discriminating since the data inputs often go far beyond traditional underwriting data use and metrics and can introduce proxy discrimination or the use of seemingly neutral factors in data sets that are not related to risk but might correlate with it, causing harm to a protected class.[35] State Senate Bill (SB) 21-169, the Colorado law, signed in July 2021, requires insurers to remediate any consumer harm if the insurers' deployment of data has been found to have unfairly discriminated on the basis of race, color, nationality or ethnic origin, religion, sex, sexual orientation, disability, gender identity, or gender expression.[36] The law targets the growing use of external consumer data, information sources, algorithms, and predictive models in the personal lines insurance industry. The Colorado Division of Insurance is working on a plan to find, measure, and remediate unfair bias in delivering insurance products to consumers.

In the year ahead, regulators are expected to continue defining how carriers can better identify and remove bias that unfairly impacts historically disadvantaged communities. Specifically, the NAIC is preparing a survey to understand the industry's use and management of big data, AI, and ML that it says could prompt the development of a potential regulatory framework in line with its *Artificial Intelligence Principles.*

Effective responses designed to address diversity, equity, and inclusion in an environment of ever-enlarging AI presence will be expected, and insurers need to stay ahead to distinguish themselves competitively as organizations that are invested in fair outcomes for consumers. They must position themselves to detect, address, and remediate bias and unfair discrimination.

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Cybersecurity and data security

Comprehensive cybersecurity risk management has become standard for insurers since the passage of the NAIC's Insurance Data Security Model Law in 2017.[37] With the exponential growth of digitization and the sophistication and prevalence of hacking, a great deal is at stake, from a company's financial stability to its reputation and the trust it has built with its supervisors and with the public. Regulators are pushing for heightened controls, more robust testing, and more detailed and faster disclosures, with ramifications for the entire industry. Compliance with the New York Department of Financial Services' (NYDFS) heightened regulatory framework requires an "all-in" approach—from IT employees and critical third parties to the C-suite and its board. In concert with this acceleration of supervisory activity, other state laws are prepped to go into effect in 2023 while the FIO will be considering with other federal partners the potential creation of a national insurance response to catastrophic cyber incidents. Insurers should explore ways to improve the agility and scope of their IT and cyber standards in the various IT domains where they can be applied.

Regulators in the United States and globally now express concern over the risk of a growing and heavily concentrated dependency on critical third-party providers as they assume control over crucial elements of company processes, extending from the cloud to data, risk assessment, and even underwriting. Merging technologies such as quantum computing, more complex cloud environments, and cryptocurrency might require adaptations in IT security and cyber practices internally, while regulators will want to know if insurers periodically test their newly acquired technology and have backup systems that can safeguard data in the event of an attack. Regulators in 2023 will likely expect greater insights on a company's stress points and the impact of an attack if crucial system points internally or externally are attacked, including the impact on balance sheets. They might also want companies to quantify or better measure their cyber risk under new standards as cyber monitoring develops and matures.

Despite increased regulatory and industry rigor, the defenses in place might not be enough or the recovery plan not able to execute well, some regulators worry. Extortion payments can be embarrassing but now need to be disclosed within tight time frames—sometimes 24 hours under a new set of rules contemplated by the NYDFS.

The NYDFS will continue to enforce its 2017 rule but is also preparing to implement expanded cyber protocols. As a vanguard regulator of cybersecurity rulemaking, the NYDFS superintendent has proposed an extensive second amendment to its ground-breaking 2017 Part 500 Cybersecurity Regulation for domiciled entities on July 29, 2022, with many more obligations for larger companies, more documentation, and enhanced C-suite involvement and expertise. These rules were proposed in a 20-page notice in November 2022.[38] The expanded regulations will likely become official sometime in 2023 once the comment period closes early in the year.[39]

Under the proposed framework, insurers and other New York state-regulated financial services entities will be subject to a designation that vastly increases their company's compliance responsibilities. "Class A" companies—that is, those with at least $20,000,000 in gross annual revenue in each of the last two fiscal years from business operations in New York, and that have more than 2,000 employees; or those with more than $1 billion gross annual revenue averaged over the last two fiscal years—will have a host of new requirements.[40] These include an independent audit of their cybersecurity program at least annually. They will also have to possess a privileged access monitoring solution and an automated method of blocking commonly used passwords for all accounts. Other proposed cyber safeguards for Class A companies include installation of an electronic system to track, identify, and respond to anomalous activity on their systems and an internal solution that centralizes logging and security event alerting.[41]

Another proposed requirement allows the NYDFS superintendent to receive—upon request—all documentation on a company's cybersecurity program, including those maintained by an affiliate and adopted by the covered insurers, so being able to maintain thorough record-keeping and show regulators system protocols are compliant will be necessary. Insurers doing business in New York will have only one month to comply with some of the required notices and certifications of leadership, with other specific compliance deadlines in place in time frames ranging from 30 days to 18 months once the amendment goes into effect. Many of the details depend on the specific requirements outlined in the proposed rule and the size of the licensed entity, so paying close attention to the final language and knowing how to put it into action within the company in a potentially short time frame, in some cases, is crucial.

There will be no respite from other states, either. Regulators indicated on an NAIC conference call in October 2022 that they were no longer going to allow companies to shield them from any cyberattack events they had sustained by claiming confidentiality. Instead, they expect fast and transparent reporting of breaches, according to the co-chair of the NAIC Cybersecurity Working Group.[42] The federal government already requires reporting of cybersecurity incidents to the Department of Homeland Security (DHS) under the Cyber Incident Reporting for Critical Infrastructure Act of 2022.[43]

Implementing end-to-end systems to embrace the growing network of rules will soon be necessary for firms operating not only in New York but in other jurisdictions that might follow the Empire State's lead.[44] Training for leadership at the board level and, most crucially, for a firm's chief information security officer (CISO)—a role spotlighted in the proposed regulation—will have to become common practice. There is a reason the CISO is mentioned almost 20 times in the proposed New York cybersecurity regulatory language. Much is expected in expertise, oversight, communication, transparency, and accountability from this role, whether it is in-house or outsourced to a third party. The CISO should be well equipped to give some comfort to regulators that the insurer is not only vulnerability-tested and resilient but can respond swiftly to an incident and have a solid recovery plan.

These existing or planned rules will require quicker responses and more frequent engagement with regulators to help chart courses in controlling data exposure and responding to breach events. Focusing more resources on operational resilience can help relationships with customers and help satisfy regulators. Tabletop exercises that involve IT departments as well as the executive suite in role-playing to respond to potential cyberattacks for operation resilience, as well as a testing of a post-attack recovery process, should be part of the company's business model now, and training of all personnel should be ongoing to meet the vulnerabilities new technological systems bring. The proposed regulations list incident detection, response, and recovery as core cybersecurity functions, among other capabilities. Companies might also want to make sure that access to data and applications is limited to only necessary employees.

Comprehensive multi-agency scrutiny on cybersecurity during a time of mounting cyber incidents, ransomware crimes, and fast-evolving technology makes it imperative that insurers invest significant resources into safeguarding information, installing sophisticated guardrails, and establishing a comprehensive management system that can satisfy regulatory compliance checklists at every stage of their operations.

As one federal US financial services regulator asked during a global insurance forum last summer: has your firm tested its backup system plan in real life? Not just "on Saturdays," when the workload is a fraction of what it usually is, but during the week, when it is at capacity? If not, that's what you need to do, this regulator advised.[45] Moreover, regulators might ask for results of those penetration tests, and insurers should be ready to share—upon request—with quick and transparent assessments and any loopholes they've uncovered.[46] Insurers should heed such counsel and make sure that controls are in place end-to-end, from domains that support IT security through all their third-party service providers.

Insurers and those that have licensed personnel doing business in New York need a strong but tailored approach to every facet of the enhanced New York requirements as they begin to take effect on a rolling basis. They will want to make sure their penetration testing reaches from both inside and outside the information systems' boundaries and is done at least annually as the proposed rule spells out; and review vulnerabilities based on risk assessments and promptly after any major system changes.[47]

Data privacy

If there is one area where all insurers, regardless of their line of coverage, need not wait to see what develops in other states or await a significant action against another company for remediation and penalties, it is in privacy and protection of consumer data. First on the world stage was the EU's General Data Protection Regulation (GDPR) law, followed by its sister version—the California Consumer Privacy Act (CCPA).[48] These rules are ushering in an era of vigorous personal data hygiene that will require sophisticated record retention and disposal management.[49] State regulators have made it their mission to protect consumers' data privacy as more opportunities for exposure and abuse arise.

Insurers should have already started putting a plan in place to sift through their virtual and even physical warehouses holding decades of PII, including how it is stored, its necessity both currently and going forward, and where it should be housed. State-based legislative activity for privacy laws is rapidly moving forward, with legislative trackers showing laws taking hold in states such as Colorado, Virginia, and Connecticut and gaining traction or in force in states such as Ohio, Michigan, and Utah as well.

Concurrently, the NAIC has tasked a committee with developing a combined model law on consumer data privacy.

The NAIC has determined that a new model law "is necessary to enhance the consumer protections and the corresponding obligations of entities licensed by the insurance department to reflect the extensive innovations that have been made in communications and technology over these decades."[50] As a result, it has tasked a committee with combining two existing model laws (the Insurance Information and Privacy Protection Model Act (#670) and the Privacy of Consumer Financial and Health Information Regulation (#672)) addressing consumer data privacy into one robust model under its newest parent committee, the NAIC's Innovation, Cybersecurity, and Technology Committee.[51] In concert with these efforts, the NAIC is developing a paper on consumer data ownership and use and has collected responses from the industry from surveys it has distributed to clarify its work. Regulators expressed concern that there is extraneous data and information on file with insurers and that consumers could be confused over opt-in or opt-out selections.[52] The NAIC's stance sets the stage for the model law championing more plain language, detailed guidance, and certain limitations in information collection from consumers.

Challenges will continue for companies to create a system to ensure sensitive customer information is safeguarded or destroyed as required, even as this data grows exponentially in the coming years. Regulators are expected to increase their scrutiny of whether data is used appropriately and is secure and well-guarded, so insurers need to remain vigilant as they put systems in place to comply and identify vulnerabilities. The White House AI "Bill of Rights" emphasizes data privacy protections.

Insurers with legacy companies and systems often have hordes of data containing personal information of customers and others, some of which had been required to be kept under previous data retention regimes. These might not work in this new environment. Cloud operations of companies might harbor private data that a company may have thought was deleted, while insurers might need to keep certain information for a strictly circumscribed time period for beneficiaries or for their own business analysis purposes.

State regulators seek answers about the scope and reach of the data collected and who owns it, as well as the control of that data. Meanwhile, Congress has considered legislation in efforts to protect consumers as data held by companies grows exponentially, and bills such as the American Data Privacy and Protection Act could gain traction in the new Congress as privacy has been a bipartisan concern. Companies should be poised to operationalize the growing requirements for disclosure as well as safeguarding of information and be aware that regulators have prioritized consumer protection—a daunting task as methods to store and access data have proliferated.

Insurers will need to check whether current practices conflict with the overarching California law and those adopted in the jurisdiction of its fellow states. Insurers also need to be ready to take requests from consumers to delete personal information if it is extraneous to an existing policy to prevent it from being exposed in the marketplace.[53]


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Capital, reserve requirements, and solvency monitoring

Whether it is through the treatment of complex structured securities or assessing new, riskier infrastructure investments, the NAIC's Securities Valuation Office (SVO) and insurance department staff that help direct its work are developing positions that could change capital requirements. Financial regulators are reviewing investments underpinning reserves by companies, particularly those investments seeking to increase yield and alternative asset security structures that might need closer evaluation.

The NAIC has been tracking collateralized loan obligation (CLO) performance and conducting stress tests for a couple of years, so its forward movement is no surprise. However, it has expressed concern for concentrated investments in Combo Notes and low-rated tranches and highlighted potential risk with significant exposure in these relative to an insurer's surplus.

As solvency considerations are foremost in financial regulators' minds, the NAIC is also seeking more information on the underpinnings of offshore reinsurance transactions that may allow for regulatory arbitrage between capital regimes. While this could result in more disclosure or restrictions in practice, it could also spark a move to changes in the United States if regulators find fault with the opacity of current alternative affiliate transactions in offshore Atlantic jurisdictions. In Washington, the FIO is analyzing the liquidity and credit risk implications of nontraditional investments and activities in the life insurance sector, specifically mentioning privately structured securities. This is a time to be at the table with regulators at the state and federal levels.

The most recent period of low interest rates spurred investments in higher-yielding investments, including CLOs—securities collateralized predominantly by a pool of below-investment-grade loans—along with other loans described as syndicated or as liens. Overall, CLOs have generally received high marks for their performance over the years, performing soundly due in part to the low default rate for bank loans. In fact, about 90% of US insurers' CLO holdings were investment grade or higher at year-end 2021. However, AAA-rated tranches declined year-over-year according to the NAIC's Capital Markets Bureau.[54] Although CLOs only represent about 2.7% of insurers' total cash and invested assets at year-end 2021, they have been increasing as a percentage of assets over the past several years, according to the NAIC.[55] The NAIC has pointed to high credit quality overall in nontraditional bonds, mitigating some concern, but is still zeroing in on CLOs and contemplating treatment that would make them more costly as investment vehicles.

The NAIC puts US insurers' CLO exposure at $216.3 billion in book/adjusted carrying value (BACV), up 12% from year-end 2020, although the pace of growth has slowed over the past few years.[56] The largest insurers are most likely to hold CLO investments and often have CLO asset manager subsidiaries, as the NAIC has noted, meaning this investment area would be impacted with the envisioned changes. Specifically, regulators are considering having insurers possibly hold more capital for CLOs, as they have expressed concern that there could be risk-based capital (RBC) arbitrage if insurers are holding less for owning the sum total of a given CLO tranche than if they were required to own the underlying collateral.[57]

NAIC working groups are looking at modeling CLO investments, examining any potential RBC arbitrage and possibly adding two new RBC factors for CLOs that would add tail risk in any structured finance tranche.[58] The life and asset management industry has expressed concern that higher RBC charges for the investments will reduce insurers' holdings in what it believes has been a tried-and-true investment record in CLO liabilities.[59] Insurers might balk at having to maintain higher capital for these investments, but there will be much task force and working group interfacing with stakeholders beforehand, with the circulation of exposure drafts expected before any capital requirements are introduced or requirements on structured securities are heightened. The RBC Investment Risk and Evaluation Working Group is considering designations and RBC factors for the equity portion of the tranche, while the Valuation of Securities (VOS) Task Force simultaneously does its work assessing risk and deciding how to proceed. In other words, when decisions are made at a higher level, there might be some proposed requirements and new designations.[60] The NAIC is serious about trying to rein in what it perceives as a potential future risk, despite a history of solid performance from CLOs.[61]

The NAIC is considering a proposed amendment to add reporting instructions for the financial modeling of CLOs. Through its groups, such as the Structured Securities Group, the NAIC said it is “only looking to model the broadly syndicated loans CLOs,” as financially modeled securities initially before eventually modeling the middle-market CLOs, according to meeting minutes from fall 2022.[62] On a separate track in its scrutiny of alternative and more complex investment activity, state regulators have also been eyeing capital management in reinsurance. This is occurring even as the FIO acknowledges in its annual report that it is scrutinizing the growth of offshore reinsurance and the growing reliance on this market by life insurers.

According to NAIC considerations in a document it adopted in August, regulators have been having “candid conversations about why some insurers are using offshore reinsurers,” including captives and affiliated ‘sidecar’ vehicles to increase capital efficiency.[63] Although clearly concerned about investment risk and other matters relating to solvency, state regulators stressed that they weren’t necessarily casting negative judgment on these arrangements but just want to have a window into the transactions so they can monitor the solvency of their domiciled companies.[64] Although regulators want to talk through the situation with industry representatives to get a better understanding of their use before they begin drawing up any plans for disclosure or new requirements, they have mentioned in their discussions the potential to expand Holding Company Act requirements with more disclosures on reserves and capital if the reinsurers are affiliated.[65]

There could be tension among industry stakeholders who have differing needs and might not use offshore vehicles. For example, certain insurers not engaged in offshore captive transactions as well as federal officials and legislators have been vocal in expressing their worries for solvency and policyholder protection with regard to these arrangements, even if these offshore arrangements boost insurers’ capital efficiency but introduce complexity into the structure of the company.

On the flip side, the NAIC could be persuaded by the life insurance industry over time to consider that the capital regime in the United States is too conservative, or has been in lower interest rate environments, and its tighter-than-desired standards for reserve buffers are driving some insurers to free up capital by financing some reserves viewed as redundant or excessive through offshore affiliates.

“If there are problems in the US regulatory system that are driving insurers to utilize offshore reinsurers (e.g., ‘excess’ reserves), we should know of those problems so we can consider if there are appropriate changes to make,” state regulators stated in a comment on the NAIC-adopted list of 13 considerations applicable, but not exclusive, to private equity (PE)-owned insurers.[66] “There isn’t a presumption that the use of these transactions is categorically bad. Rather, there is a need to understand the economic realities of the transactions so the regulators can effectively perform their solvency monitoring responsibilities,” the financial investment regulators wrote.[67]

Regulators, legislators, and supervisory membership organizations at the state, federal, and even international level are also looking at alternative capital, leverage, and PE in the pension risk transfer business for any financial stability issues and making certain that investments match the long-term goals of the pension business. Most recently, the International Association of Insurance Supervisors (IAIS) identified PE involvement in the life insurance sector as one of the top three macroprudential themes in its 2022 global risk assessment report released in December 2022. “Some of the observed business strategies applied by PE-involved insurers have been identified as generating additional micro- and/or macroprudential concerns in some jurisdictions,” the report stated.[68] Scrutiny will almost certainly continue or even grow in 2023.[69]

Before the NAIC adjusts capital and/or reserve requirements, the give-and-take in dialogue with industry and other stakeholders is anticipated to be comprehensive and lively before it yields new or enhanced requirements. Insurers would be mindful to review their own position in relation to these subject areas that regulators are currently reviewing and be ready to discuss it fully and openly.

Internationally, the Insurance Capital Standard (ICS) is steeped in discussions and in a monitoring period among global regulators, but it is not ready for supervisory deployment yet. Final modifications are expected by 2025, at the end of the five-year monitoring period stretching from 2020 through 2024, when it would be implemented as a prescribed capital requirement, acting as a common language for regulators around the world to more uniformly assess the capital adequacy of the insurance firms they supervise.[70] There are currently nine US Internationally Active Insurance Groups (IAIGs) among 48 globally. The nation's homegrown Aggregation Method (AM) for group capital will be assessed for comparability to the ICS in the second half of 2023 under criteria expected to be finalized in the first quarter under the supervision of the IAIS.[71]

"Some of the observed business strategies applied by PE-involved insurers have been identified as generating additional micro- and/or macroprudential concerns in some jurisdictions," the report stated. Scrutiny will almost certainly continue or even grow in 2023.

Consumer protection

The vulnerability of consumers is a key concern among regulators among a swath of agencies from federal overseers to state insurance and securities departments. If there were any doubt regulators were going to stay focused on consumers and even sharpen their surveillance and protections, it was put to bed when NYDFS Superintendent Adrienne Harris relaunched and expanded the membership of the Department of Financial Services Consumer Protection Advisory Council, with its first meeting in late September 2022.[72]

P&C sector

State regulators leaned into their roles to protect consumers during the ongoing COVID-19 pandemic with auto insurance pricing to make sure rates reflected lower mileage. Now, things have changed, with driving miles rebounding and the expense and severity of auto accidents trending much higher, and carriers are trying to raise rates to keep up with costs—if they are permitted to.[73] At the same time, there will be increasing tension between property and casualty (P&C) insurers and regulators on premium charges as carriers argue for risk and regulators worry about affordability amid the rising costs of auto and homeowners' products.[74]

To be sure, in the P&C insurance arena, state officials are actively trying to thwart moves they believe harm or hamper customers. But cost drivers pushing up the combined ratio well past 100% for auto insurers are resulting in proposed rate increases unpalatable to some state insurance commissioners looking to keep premiums affordable. This is causing increasing tension between the industry and state insurance actuaries and others overseeing rates, with press attention locally and nationally about rising auto rates coupled with regulatory concerns about the impact of these rising premiums on consumers for auto and homeowners insurance.[75]

The FIO has a role to play in availability and affordability of insurance coverage under the Dodd-Frank Act, and one of its backers, then-House Financial Services Chair Maxine Waters has raised affordability issues for consumers in hearings in the fall, expecting answers for her constituents in California at a minimum.[76] Congressional attention has been directed not only at homeowners but also with respect to auto insurance pricing. With concerns about the impact of the price of auto insurance with rising inflation, there is a growing consumer group backlash against higher insurance auto rates as well as companies' rating systems for different profession classes of drivers in states that require prior approval.[77]

This strongly fueled consumer interest adds pressure on insurance commissioners who need to preapprove rate increases. California had argued, for instance, that auto insurers made a profit—even with rebates—from people driving less during the COVID-19 shutdown; but loss costs from severity of accidents, labor costs, and inflation are rising, insurers and their advocates argue. In fact, fatalities in accidents recorded recently have eclipsed those of recent years with the first quarter of 2022 seeing more fatalities than in 2002.[78]

In the fall of 2022, California Insurance Commissioner Ricardo Lara, through his general counsel, demanded that auto insurers reveal within 30 days specific information about their pandemic-era claim costs to check whether they overpaid in the period from March 2020 to at least March 2021.[79] The California Department continued to scrutinize as many as 50 or more auto insurers to help benefit those policyholders who were overcharged, according to the letters. P&C insurers have argued against retroactive rate increases as unsupported by the courts. They have also warned of their ability to operate in the state.[80] Friction on auto rates is expected to continue as auto insurers seek higher premiums to reflect the risks they undertake. State regulators are geared up to protect consumers against high auto insurance rate hikes in some major markets. But for every action there is a reaction: P&C insurers are contemplating cutting market share in homeowners and auto insurance in states such as California where they are not getting requested rate increases in the face of rising loss costs. This can create further tensions as state insurance actuaries grapple with expense trends while keeping coverage affordable.[81]

Federal and state regulators will also continue to protect consumers from predatory and fraudulent marketing schemes.[82] The NAIC, too, might be cracking down on some marketers if it expands its Unfair Trade Practices Act.[83] As always, the insurance sector should strive to differentiate its producer community from those engaging in unscrupulous behaviors.

Life sector

Meanwhile, the Best Interest (Reg BI) regulatory framework will likely act on a host of new enforcement capabilities after a more relaxed era in federal and state sales practice market conduct.

With the Reg BI regime now more entrenched at the state and federal levels, regulators have more tools in place to help safeguard the consumer. A June 2022 SEC enforcement action against a firm and five brokers has put the industry on notice.[84]

At this time, state insurance oversight officials have not taken any significant public action on their own updated version of sales practices standards thus far, otherwise known as the revised NAIC Suitability in Annuity Transactions Model Regulation.[85] This revised model law added a best interest standard of conduct for insurers and producers in the sale of annuities and life insurance in alignment with federal securities regulation. At least 30 states now have adopted the revised model or an alternative and at least a half dozen are pending, with some state laws becoming effective in January 2023. This widening reach of Reg BI scrutiny by multiple agencies could turn up the heat on sales practices of insurance agents and producers.[86] New York's comprehensive and detailed rule will likely be wielded now that the state's high court has reinstated the 2018 amendment adding a best interest standard. A lower court had earlier ruled it unconstitutional, a position that was overruled in October 2022.[87]

FINRA and the US Department of Labor (DoL) are also driving home the compliance obligations and fiduciary standards, documentation expectations, and disclosure requirements for regulated entities now that a relatively fallow period of little enforcement is ending. Financial enforcement professionals have applauded leading practices that include careful crafting of a solid risk-based approach to policies and procedures at firms.

Federal financial enforcement agencies such as FINRA have faulted firms that have not followed through on their own conflict of interest obligations, procedural inadequacies, and the consideration of reasonable alternatives and costs associated with all aspects of an investment. FINRA has noted that 2021 was the first full year that it examined firms' compliance with the full scope of Reg BI-related measures, and in a report in 2022, it delivered a long list of shortcomings and oversights from imprecise guidance to inadequate controls, staff preparation, and training, as well as failure to comply with the conflict-of-interest obligation.[88] The findings gave firms sufficient information to identify shortcomings, and FINRA and others are now expected to act more forcefully against perceived lax performance.

Investment advisers have been subject to enforcement under compliance rules regarding IRA rollovers, impartial conduct standards, and fiduciary acknowledgment requirements for the sales of retirement savings products beginning in 2022, after the expiration of the DoL's Temporary Enforcement Policy for prohibited transactions rules. Enforcement actions for documentation and disclosure requirements for IRAs are also under the microscope now. PTE 2020-02, known as "Improving Investment Advice for Workers & Retirees," allows prohibited transaction exemption under ERISA if fiduciary advisers act in the best interest of IRA customers.[89] They must render advice that is in their plan and in IRA customers' best interest in order to receive compensation or commissions that would otherwise be prohibited. The regulation, which had been sitting on a shelf for a year, will be used by the DoL as part of its enforcement arsenal. The goal is to protect consumers by ensuring they are getting a product tailored to their retirement needs, with reasonable fees and all the necessary disclosures.

With a bevy of regulatory professionals surveying all aspects of the investment and retirement business, insurers need to fortify their compliance procedures and have processes in place to make sure employees and agents are following through on them. With the Reg BI enforcement getting a foothold, now is the time to get ahead of problems through internal audits of sales practices and employing technology to ferret out high-risk sales or communications that could be problematic, especially any patterns of misconduct, and addressing any instances of these with urgency.

The myriad of supervisory mechanisms designed to keep customers protected coupled with the time insurers have had to prepare points to the expectation that enforcement of regulations will take root in the coming year. Well-managed internal company controls that ensure follow-through in all stages of the sales process along with meticulous record-keeping will be a necessity in 2023.

The age of siloed requirements for specific areas is vanishing as regulatory concerns spanning cybersecurity resilience and recovery, to the use of AI, to climate risk planning and disclosures will reach every part of a company's operations.

Data and Disclosures: Take a holistic approach

The year ahead will likely see increased regulation that governs the insurance industry's compliance requirements, adding more complexity and the need for greater oversight of all aspects of the company. Insurers need to approach compliance in a holistic fashion to make sure ESG compliance protocols are enacted across their organizations, including their affiliates. The age of siloed requirements for specific areas is vanishing as regulatory concerns spanning cybersecurity resilience and recovery, to the use of AI, to climate risk planning and disclosures will reach every part of a company's operations.

Insurers that are already positioned well and are nimble in the face of changing market conditions, altering investments, and products to reflect market pressures—as well as geopolitical and climate risk—should take action to adhere to emerging requirements and to existing rules that have been on the books since the start of the pandemic. They also need to be ready to account for investment and market practices that might be permitted but that are raising eyebrows at the federal and state levels.

Insurers with international presence should not rely on the expectation of drawn-out court battles before doing the heavy work of aligning their companies' compliance frameworks with pending or anticipated regulations. While public policy and sympathies can shift, requirements might already be in place or expected globally.

Insurers should work now to implement robust internal systems that will be ready when challenged by outsized storms, catastrophic security breaches, and the potential for algorithmic bias as well as robust regulatory and legislative inquiries into their responses to these events and uses.

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