Order Code RS21828
April 28, 2004

CRS Report for Congress
Received through the CRS Web

Insurance Regulation: International Developments

name redacted
Insurance Consultant
Government and Finance Division

Summary

Events and entities outside the United States are affecting or may affect the competitive position of U.S. insurers, in two ways. First, supranational organizations are developing international standards for insurance accounting and for aspects of supervision, such as reinsurance supervision. Second, U.S. insurers are operating under a much more fragmented regulatory regime than their competitors in other countries, such as the U.K., that are consolidating and modernizing their supervision. International standards and regulatory competition are important parameters on the U.S. industry's access to capital and therefore on its ability to provide innovative and traditional risk financing in the United States. This report was written under the research supervision of Barbara Miles, Government and Finance Division, and will be updated as events warrant.

Introduction

Economists generally agree that, while capital markets are not perfectly integrated internationally, they are far more integrated than was true only 20 years ago.[1] This integration has created pressures for enhancing transparency in the capital markets and for curtailing risks of "contagion."[2] Several supranational organizations are addressing these pressures, some specifically with respect to insurance. New international accounting standards may import new definitions of "insurance," and new transparency standards for reinsurers may help buyers shop for risk financing. At the same time, many other developed countries are synthesizing their supervision of financial services, while in the United States insurance regulation remains fragmented. These trends will likely affect the

[1] CRS Report RL30514, *Global Capital Market Integration: Implications for U.S. Economic Performance*, by (name redacted).

[2] Ibid.; CRS Report RL32354, *European Union — United States: Financial Services Action Plan's Regulatory Reform Issues*, by (name redacted).

competitive positions of U.S. insurers and reinsurers, though it is not clear presently what the direction and scope of those changes might be.

International Accounting Standards for Insurance

The International Accounting Standards Board[3] (IASB) has determined to create principles-based accounting for insurance contracts in two stages. Phase I was released on March 31, 2004, as International Financial Reporting Standard 4 (IFRS 4).[4] It is scheduled to become effective in the European Union (EU) on January 1, 2005. European insurers have objected to Phase I because, among other things, it would require them to measure derivatives at fair or market value and to show their annual gains and losses on them. Derivatives do not appear on European balance sheets currently, as they have little or no initial cost. U.S. insurers that are publicly traded already measure their derivatives at fair value.[5] U.S. insurers objected to several other aspects of IFRS 4.[6]

Phase II has just begun and will likely be implemented in 2008.[7] The U.S. standard-setter — the Financial Accounting Standards Board (FASB) — has agreed to work with IASB in converging international and U.S. accounting standards.[8] The National Association of Insurance Commissioners (NAIC) has decided to work closely with the IASB to incorporate its regulatory perspectives into development of Phase II.[9] Several issues will have significant effect on the capital positions of U.S. insurers. One will be whether and how to measure insurance liabilities at fair value. Another will be whether and how to unbundle various kinds of insurance contracts. Insurers are also concerned about how the IASB will treat reserves for losses and expected investment income and premium on long-term contracts, among other issues. They fear that the Phase II rules will lead to greater volatility in their public disclosures, and thus affect their capital positions — and the market's perception of their capital positions — unfairly and

---

[3] Further information and background on the Board and its activities are available at [http://www.iasb.org/], visited April 20, 2004.

[4] For a brief discussion of the overall project and the new guidance, see [http://www.iasb.org/news/index.asp?showPageContent=no&xml=10_116_25_31032004_31032005.htm], visited April 20, 2004.

[5] Andrew Parker and Charles Pretzlik, "Take It or Leave It," *Financial Times*, March 30, 2004.

[6] The comments letters on Phase I of the project may be reviewed at [http://www.iasb.org/current/comment_letters.asp?showPageContent=no&xml=16_46_79_10122003.htm], visited April 23, 2004.

[7] Sam Gutterman, "International Financial Reporting Standards and Insurance," *Society of Actuaries: Reinsurance News*, no. 53, March 2004, pp. 12-18.

[8] Financial Accounting Standards Board, "Convergence with the International Accounting Standards Board," available at [http://www.fasb.org/intl/convergence_iasb.shtml], visited April 23, 2004.

[9] National Association of Insurance Commissioners, "The NAIC Team Approach to IASWG Technical Support," *International Accounting Update*, vol. 3, April 9, 2004, available at [http://www.naic.org/frs/international_insurance_accounting/newsletters/newsletter.pdf], visited April 23, 2004.

incorrectly, in their view.[10] Whether those fears are justified or appropriate is unclear at this stage — but it is clear that Phase II of the IASB's proposals will greatly affect insurers' competitive position in the financial services sector.

International Standards for Reinsurance

Rightly or wrongly, insurance has been identified as "the weakest link in the finance-industry chain."[11] Reinsurance has been identified as "occupying a position of systemic importance to the insurance industry ...."[12] Reinsurers lost about $40 billion on September 11, 2001, and they lost about that much as the equities bubble burst.[13] Financial supervisors began to regard reinsurance — again, rightly or wrongly — as a systemic risk.[14]

In September 2002, the Financial Stability Forum (FSF)[15] said that though the reinsurance industry had performed well, FSF members were concerned about the opaqueness of the reinsurance market and of individual reinsurers' disclosures. It charged the International Association of Insurance Supervisors (IAIS) with producing data on the market and with enhancing reinsurers' disclosures qualitatively and quantitatively.[16] The IAIS's task force — known as Task Force Re — submitted its report to the FSF in March 2004.[17] It described how data on the international reinsurance market will be gathered and published, noted that the IAIS has drafted a standard on what non-life reinsurers should disclose about their technical performance, and said that IAIS would be preparing global reinsurance market reports.[18] Data on U.S. reinsurers will be compiled by the NAIC and

---

[10] Gutterman, *Reinsurance News*, pp. 17-18; David Pilla, "Global Accounting Accord Eludes Insurers," *BestWire*, March 31, 2004.

[11] "Poor Cover for a Rainy Day," *The Economist*, March 8, 2003, p. 65 (acknowledging, however, that American insurers are in better condition than European insurers).

[12] Udaibir S. Das, Nigel Davies, and Richard Podpiera, "Insurance and Issues in Financial Soundness," *International Monetary Fund Working Paper No. WP/03/138*, p. 16, available at [http://www.imf.org/external/pubs/ft/wp/2003/wp03138.pdf], visited April 23, 2004.

[13] Swiss Re, "World Insurance in 2001: Turbulent Financial Markets and High Claims Burden Impact Premium Growth," *Sigma No. 6/2002*, Oct. 31, 2002, available at [http://www.swissre.com/INTERNET/pwsfilpr.nsf/vwFilebyIDKEYLu/SHOR-5GFJ8G/$FILE/sigma6_2002_e.pdf], visited April 23, 2004.

[14] International Association of Insurance Supervisors, "Enhancing Transparency and Disclosure in the Reinsurance Sector: Report Presented to the Financial Stability Forum," March 2004, available at [http://www.iaisweb.org/143taskforcerereport5april2004.pdf], visited April 23, 2004 [hereafter "*Task Force Re Report*"], p. 7.

[15] The FSF, an initiative of the G7 Finance Ministers and Central Bank Governors, convened first in 1999, and is charged with strengthening the international financial system; see [http://www.fsforum.org/about/what_we_do.html], visited April 23, 2004.

[16] Eighth Meeting of the FSF (Sept. 3-4, 2002), *Press Releases 2002*, available at [http://www.fsforum.org/press/press_releases_44.html], visited April 23, 2004.

[17] *Task Force Re Report*, supra note 15.

[18] Ibid. See Appendices 3 through 5 (pp. 37-50), 9 (pp. 65-68), and 11 (pp. 71-72).

will likely be available to the Treasury, the Federal Reserve Board, and the SEC.[19] The FSF, in receiving the report, urged that "more work be done in this complex area."[20]

In October 2003, the IAIS adopted a new standard on supervising reinsurers.[21] The standard addresses reinsurers' risk management, relations with its ceding insurers, investments and liquidity, economic capital requirements, and corporate governance. It also imposes on the home supervisor of an internationally active reinsurer the obligation to share information about that reinsurer with other ("host") supervisors. It expressly contemplates "a global supervisory framework" based on "a system of accreditation of home supervisors"and this standard.[22] Though IAIS has begun a survey of its members' supervision of reinsurers, it has not fixed a timetable for creating a global regulatory regime for reinsurers.[23]

Regulatory Modernization in Other Countries

Some developed nations have unified their own supervisory regimes for financial services. Comprehensive regulatory reform of financial services began in Australia in 1996. Since then the U.K., Germany, and Japan have also unified their national supervisory regimes for all financial services sectors. Each country has taken a slightly different approach. Australia formed one agency to craft and administer consistent and comparable disclosure requirements for a broad range of products, including deposit accounts, securities, insurance products, and pensions. It formed another agency to perform prudential supervision for bank and non-bank financial intermediaries. Germany unified financial supervision of banks, securities, and insurance into one regulatory agency to achieve consistent supervision of different sectors and of cross-sectoral issues. Japan's new Financial Services Agency, which reports directly to the Prime Minister's office, supervises banks, private insurers, securities, and securities markets.[24]

Perhaps of greatest interest — because it is most accessible — is the U.K.'s undertaking to unify its supervision of financial services. The unification process began in 1997, and the new Financial Services Authority (FSA) acquired its full powers in 2001. It now regulates banking, insurance, pensions, and securities, though the process of integrating those functions continues.[25] The FSA's enabling legislation gave it four

---

[19] Ibid., Appendix 3, pp. 40-41. NAIC will prepare the data with its special insurance accounting.

[20] Eleventh Meeting of the FSF (March 29-30, 2004), *Press Releases 2004*, available at [http://www.fsforum.org/press/press_releases_64.html], visited April 23, 2004.

[21] International Association of Insurance Supervisors, *Supervisory Standard No. 8, Standard on Supervision of Reinsurers*, available at [http://www.iaisweb.org/184reinsurers03.pdf], visited April 23, 2004.

[22] Ibid., p. 3.

[23] Edward Ion, "An Idea Whose Time Has Come?" *Insurance Day*, Oct. 14, 2003.

[24] Heidi Mandanis Schooner and Michael Taylor, "United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets," *Texas International Law Review*, vol. 38, spring 2003 [hereafter "*Regulatory Challenges*], pp. 317-345.

[25] Financial Services Authority, *Summary Annual Report 2002/03*, pp. 33-37, available at

(continued...)

objectives — maintaining market confidence, promoting public awareness, protecting consumers, and reducing financial crime. In pursuing those objectives, the FSA is directed to:

- Use its resources in the most efficient and effective manner;
- Recognize that a firm's senior management bears ultimate responsibility for its risk management and internal controls;
- Make sure that burdens imposed on firms and markets are in proportion to the expected benefits for consumers and the industry;
- Facilitate innovation in the financial services markets;
- Acknowledge the "international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;"[26]
- Minimize regulation's adverse effects on competition; and
- Promote competition among regulated entities.[27]

According to the FSA, the "insurance sector is a key part of the UK financial services industry. It is important, both from an economic and social perspective, that the UK has an insurance market that operates effectively [and] remains competitive in European and world markets...."[28] According to the FSA, its creation "as a single regulator highlighted differences between the regulation of insurance and other sectors in respect of similar types of risks."[29] Accordingly, it has undertaken a major overhaul of insurance regulation to strengthen it and "to establish a common, risk-based approach to regulation across all financial sectors."[30]

In revising its insurance regulation, the FSA has cooperated closely with and contributed to both the formulation of EU directives on insurance and reinsurance as well as IAIS standards. The EU's Financial Services Action Plan (FSAP), due to be completed next year, contains directives that will directly affect the relative competitive positions of U.S. and U.K. insurers including Lloyds.[31] In addition, the European Commission (EC) has proposed a directive on reinsurance that would allow a reinsurer domiciled and licensed in an EU country, under the new standards, to do business throughout the EU

---

[25] (...continued)
[http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03summary.pdf], visited April 25, 2004.

[26] Financial Services and Markets Act, 2000, c. 8 (Eng.), Part 1, sec. 1, available at [http://www.fsa.gov.uk/fsma/data/fsma/act/act_part_i.htm#2], visited April 25, 2004.

[27] Ibid.; Financial Services Authority, *A New Regulator for the New Millennium*, Jan. 2000, available at [http://www.fsa.gov.uk/pubs/policy/p29.pdf], visited April 25, 2004.

[28] Financial Services Authority, *The Future Regulation of Insurance*, Oct. 2002, p. 7, available at [http://www.fsa.gov.uk/pubs/policy/bnr_progress3.pdf], visited April 25, 2004.

[29] Ibid., p. 3.

[30] Financial Services Authority, *Annual Report 2002/03*, p. 85, available at [http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03sec5.pdf], visited April 25, 2004. Appendix 8, pp. 205-210, shows absolute costs of financial sector regulation in different countries.

[31] CRS Report RLF32354, *European Union — United States: Financial Services Action Plan's Regulatory Reform Issues*, by (name redacted).

without further regulation or collateral. The directive is intended to, among other things, improve access to foreign markets — particularly the United States.[32]

Unified supervision of financial services may not be successful. Certainly neither Australia's nor the U.K.'s financial supervisory authority has been free from failures. The efforts are noteworthy, however, for two reasons. One is that their changes may, like the proposed EU directive on reinsurance, directly affect the competitive positions of U.S. insurers and reinsurers. The other is their express emphasis on maintaining the competitiveness of their domestic insurers in a worldwide market.[33]

Conclusion

Representative Oxley, Chairman of the House Financial Service Committee, has outlined a road-map to insurance regulatory reform. He and Representative Baker, Chairman of the Subcommittee on Capital Markets, Insurance and Government-Sponsored Entities, have proposed achieving uniformity in some aspects of state-based insurance regulation by imposing federal standards but not federal regulation.[34] Chairman Oxley, in expressing his support for such reforms, said that "(i)nsurers are facing increasing competition from other financial services sectors which have significantly lower regulatory costs.... If insurers cannot raise new capital, this marketplace is at risk for a major collapse. Without change, consumers face a world with fewer options, less competition, and less coverage."[35] At the Subcommittee's hearing on March 31, 2004, Representative Kanjorski expressed support for those goals and initial doubt about whether the proposal as outlined could achieve them. Senator Hollings, Ranking Member of the Senate Committee on Commerce, Science, and Transportation has introduced S. 1373, the Insurance Consumer Protection Act, to mandate federal regulation of insurance.

As Congress continues its efforts to modernize insurance regulation, entities in other countries are taking steps that will affect the competitive positions of U.S. insurers. The NAIC is working closely with Congress to assist in its efforts. It is also working closely with international entities, particularly the IAIS, to develop new international standards for insurance regulation. It remains to be seen whether or how all these efforts will coordinate for the benefit of the United States as a whole.

---

[32] Commission of the European Communities, *Proposal for a Directive of the European Parliament and of the Council*, SEC(2004)443, April 21, 2004, available at [http://europa.eu.int/comm/internal_market/insurance/docs/reinsurance/directive/com-2004_273-final-en.pdf], visited April 25, 2004. In the U.S., reinsurers that are not licensed in a state must commit collateral in the U.S. at least equal to the gross amount of their U.S. liabilities. Non-U.S. reinsurers object to the requirement as a trade barrier, while many U.S. insurers favor the requirement. See Michael Loney, "The Collateral Battle," *Reactions*, Nov. 2003.

[33] Schooner and Taylor, *Regulatory Challenges*, pp. 343-345. See also Kenneth K. Mwenda and Judith M. Mvula, "A Framework for Unified Financial Services Supervision: Lessons from Germany and Other European Countries, *Journal of International Banking Regulation*, vol. 5, Sept. 2003, pp. 35-56.

[34] Chairman Michael G. Oxley, "Road Map to State-based Insurance Regulatory Reform," speech to the National Association of Insurance Commissioners, March 14, 2004 (released March 15, 2004), available at [http://financialservices.house.gov/news.asp], visited April 25, 2004.

[35] Ibid.