Insight

Forthcoming Group Capital Requirements Inappropriate for U.S. Health Insurers

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Executive Summary

- The National Association of Insurance Commissioners (NAIC) is working to create a national group capital calculation for insurers.
- The proposed standard would mirror European group regulation despite the significant differences between both U.S. and European regulatory approaches and U.S. and European insurers.
- Particularly adversely affected would be U.S. health insurers, which have no European equivalent. Health insurance is expressly excluded from the regulatory authority of the Federal Insurance Office, and many are hoping that the NAIC will clarify the applicability of the group capital calculation to health insurers.

Background

Insurers in the United States have historically been regulated at the state level. Unlike in Europe, where insurers are supervised and assessed at the group or holding-company level, insurance companies are assessed as individual entities by insurance commissioners. The commissioners have organized themselves as the National Association of Insurance Commissioners (NAIC). The NAIC is not a regulator – state insurance commissioners have not ceded regulatory authority – but rather acts as support system and indicator of best practice, while also representing the commissioners nationally and internationally. States may choose the extent to which they apply NAIC recommendations, leading to regulatory and capital regimes that vary from state to state.

The United States and European contrasting regulatory approaches co-existed until the 2007-2008 financial crisis. In Europe, pressure emerged to develop and introduce global standards for insurance regulation. The International Association of Insurance Supervisors (IAIS) greatly expanded in scope, and in 2009 the EU enacted Solvency II, an extraordinary raft of legislation harmonizing insurance regulation across all 28 member countries. In the United States, Dodd-Frank reform established the Federal Insurance Office (FIO) within the Department of the Treasury, which represented a significant pressure for insurance regulation at a federal level. The law also designated FIO – not the NAIC – to represent insurers in international agreements.

In 2012, the Financial Sector Assessment Program (FSAP), a World Bank/IMF country-level review of financial stability and the financial sector's capital holdings, found that the U.S. state-based insurance model did not adequately supervise or calculate capital at a group level. The NAIC accordingly began working toward a group capital calculation methodology.

Also in 2012, FIO convened the EU-U.S. Insurance Dialogue Project, which would work toward increased cooperation and ultimately harmonization of EU and U.S. insurance supervision. Each party had a major objective: For the EU it was for the United States to reduce the collateral it required European reinsurers to hold in the United States; for the United States it was to be deemed "equivalent" under Solvency II – i.e. that U.S. methodologies be deemed sufficient protection for policyholders, as if insurers were operating under European regulations. To be recognized as equivalent would significantly decrease the costs for U.S. companies operating in Europe. Per the agreement the final text was sent to Congress in January 2017, and the parties formally signed the covered agreement in September 2017.

Here is where things get interesting. Once the agreement's transition period of five years is complete, the agreement will eliminate the reinsurance collateral requirements for EU reinsurers. It will also deem the U.S. regulatory regime "equivalent" – but *only* if the United States implements group capital standards for U.S. insurers (as also noted by the FSAP). In signing this agreement, FIO, via the Dodd Frank Act, has therefore pre-empted state-based regulation – at the initial outrage of the NAIC – by imposing a national insurance regulatory requirement. True, the NAIC has been working on a group capital standard since 2012, but there is now a five-year deadline for this regulation to be designed and implemented or equivalence will not be obtained. Relatedly, that FIO should have this unilateral power to engage in international agreements is now under significant challenge.

This looming group capital calculation represents a particularly worrying development for U.S. health insurers.

Health Insurance in the United States

The U.S. health insurance industry is unique both in relation to its European counterparts and as compared to other forms of insurance. Health care costs are known and paid quickly; the industry is not dependent on investment performance nor has suffered a catastrophic event. Europe simply doesn't have a comparable private health insurance market – health insurance is not even mentioned in the covered agreement. In the United States, Title V of Dodd-Frank explicitly removed health insurance from the purview of FIO, raising questions of the legitimacy of FIO's ability to impose regulations on U.S. health insurers.

For its part, the NAIC, after its initial protests, eventually approved of the covered agreement and is working to craft a group capital calculation by the required deadline – and it appears to be including health insurance within the scope of these regulations. (To be clear, NAIC itself does not have the authority to impose regulations; FIO would accept and implement NAIC's capital calculation methodology.) The NAIC argues that the group capital standard is a tool for insurers to use and not a requirement – relying on regulatory forbearance is, however, simply not that convincing an argument, particularly following the NAIC's decision to propose an operational risk capital requirement for health insurers.

Impacts of Inclusion

What does this mean for U.S. health insurers? The new requirements could add billions of dollars in costs to U.S. health insurance. A group capital standard is not innately superior to entity-level supervision. Group capital is fungible and can move freely from entity to entity – which makes assessing the solvency of an individual entity that much more difficult. Of particular concern is that a group capital standard will also presumably factor in non-health subsidiaries. Extremely low risk health-related service entities – for example, those that provide medical IT – will also be assessed as part of this calculation. Overnight, health insurers will appear to be undercapitalized for entirely artificial reasons.

And what of the costs to health insurers? Costs will necessarily be passed to the consumer, most likely in the form of increased premiums. Increased costs to health insurers don't simply affect the consumers of a particular health insurer, but also companies with employee insurance plans. Further, as European health insurance doesn't operate in the same way, this penalty will significantly decrease U.S. market competitiveness. This will have a direct impact on the availability and quality of health insurance.

Conclusions

The Trump Administration has indicated that it wants more competition in the health insurance industry but additional capital requirements for health insurers is no way to achieve this goal. On top of raising costs for consumers this new regulation would make it much more difficult for new insurers to enter the market while possibly pushing some existing players out. It is up to Congress to clarify congressional intent regarding the covered agreement and influence how FIO and the NAIC proceed prior to implementation of the new standard.