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Effects of the Financial Crisis in Insurance Regulation: New Challenges

Efectos de la crisis financiera en la regulación de seguros: Nuevos Desafíos

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U.S. Financial Regulatory Reform

- On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA).

- The Bill is over 2300 pages long and consists of 17 Titles.

- Much of it relates to issues that are unrelated to insurance; however, the new law does establish a new federal role regarding insurance in a number of critical respects.

Federal Insurance Office (Title V, Subtitle A)

- Establishes a Federal Insurance Office (FIO), housed in the Treasury Department
- Help the federal government gain a better understanding of the insurance market and negotiate international agreements
  - Does not give Treasury general supervisory or regulatory authority over the business of insurance.
- IL Insurance Director Mike McRaith, named by Treasury as the first Director of the FIO

Federal Insurance Office: Covered Agreements

- The Treasury department and the USTR have authority to enter into “covered agreements” - international agreements that preempt state law if they are:

1) entered into between the U.S. and a foreign government, authority, or regulatory entity, and

2) relate to the recognition of prudential measures to the business of insurance or reinsurance *that achieves a level of protection of insurance or reinsurance consumers that is substantially equivalent to the protection achieved under state law*.

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Federal Insurance Office: Covered Agreements

- Preemption shall not include:
  - any State insurance measure that governs any insurer's rates, premiums, underwriting, or sales practices;
  - any State coverage requirements for insurance;
  - application of the antitrust laws of any State to the business of insurance;
  - or any State insurance measure governing the capital or solvency of an insurer, except to the extent that such State insurance measure results in less favorable treatment of a non-United State insurer than a United States insurer;

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Reinsurance Provisions (Title V, Subtitle B)

- Prohibits a state from denying credit for reinsurance if the state of domicile of an insurer purchasing reinsurance (ceding insurer) recognizes credit for the reinsurance for the insurer's ceded risk and is either an NAIC-accredited state or has financial solvency requirements substantially similar to NAIC accreditation requirements.

- Reinsurer's domiciliary state is made solely responsible for solvency regulation, provided that the state is accredited by the NAIC or has financial solvency requirements that are substantially similar to NAIC accreditation requirements.

- The new reinsurance law <u>does not</u> address collateral.

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Financial Stability Oversight Council (FSOC): (Title I)

- Financial Stability Oversight Council to identify risks to U.S. financial stability from the ongoing activities, material distress or failure of large interconnected financial companies, including insurance companies.

- FSOC will consist of 10 voting members, including an independent member with “insurance expertise.”

- The Council shall also have five non-voting members including a state insurance commissioner and the director of the newly-created Federal Insurance Office.

- State insurance regulators also have responsibilities on the Financial Stability Oversight Council (FSOC), though our designated representative, Director Huff of MO.

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Overview of FSOC Activities

- The Council has met 4 times on October 1, November 23, January 18, and March 17.

- It has focused on three main areas that could have an impact on insurers:

  - Designations of Non-Bank Financial Companies for supervision by the Fed

  - Conducting a study and making recommendations on implementing the Volcker Rule

  - Conducting a study and making Recommendation of implementing concentration limits on large financial firms

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Inadequate Insurance Expertise on FSOC

- In the nearly nine months since FSOC began its official operations, the Council has been working at a furious pace.
- While FSOC engages in work that could impact insurers, two of the three insurance representatives are absent from the table.
- Unfortunately, the only seat at the table having to do with insurance is that of Director Huff of the Missouri Insurance Department.

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Designations of Non-Bank Financial Companies for Supervision by the Fed

- Under the DFA, FSOC has the authority to require that a non-bank financial company (including certain insurers) be supervised by the Federal Reserve and be subject to heightened prudential standards if the Council determines that:

  "material financial distress at such a firm, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the firm could pose a threat to the financial stability of the United States."

- At the October 1 meeting, the Council issued an Advance Notice of Proposed Rulemaking regarding designating non-bank financial companies. In that notice, the Council asked potential commenters a number of questions including what metrics the council should consider, what types of companies should be considered for designation, and how international considerations should be taken into account.

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Designations of Non-Bank Financial Companies for Supervision by the Fed

- At the January 23 meeting, the FSOC issued its proposed rule for designating non-bank financial companies to be supervised by the Fed.

- The interpretative guidance indicates that the FSOC will consider the following 6 categories in making its determination:

  - Size;
  - Lack of substitutes for the financial services and products the company provides;
  - Interconnectedness;
  - Leverage;
  - Liquidity risk and maturity mismatch; and
  - Existing regulatory scrutiny.

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Designations of Non-Bank Financial Companies for Supervision by the Fed

- It is anticipated that the FSOC will finalize its rule sometime early Summer, and then begin to designate non-bank financial companies for supervision by the Federal Reserve.
  - FSOC is required to consult with the primary financial regulator of any company being considered for designation prior to making its final decision regarding such designation.
  - Once companies are designated, the Fed will impose heightened prudential standards on such companies. FSOC is statutorily authorized to provide recommendations to the Fed on such prudential standards.

Implementation of the "Volcker Rule"

- Section 619 of the Dodd-Frank, the "Volcker Rule", and prohibits "banking entities," from engaging in proprietary trading (i.e., trading for their own account) or investing in a hedge or private equity firms except in circumstances where they engage in certain "permitted activities."

- The Dodd-Frank Act charged FSOC with conducting a study and providing recommendations as to how best to implement Section 619 of the Dodd-Frank Act within 6 months. As part of the study and recommendations, FSOC was required to make findings that will appropriately accommodate the business of insurance.

Implementation of the "Volcker Rule"

- On January 18, 2011, the FSOC issued its study.
- While recommending that insurance investments for the general account should be permitted because they are critical to the insurer business model, the section regarding how insurance investments are to be treated was fairly non-prescriptive:
  - The agencies should define the following statutory terms: "regulated insurance companies," "directly engaged in the business of insurance," and the "general account."
  - The agencies should consider the timing and approach to the assessment of insurance company investment laws, regulations, and guidance in determining whether such laws adequately protect a given institution or the financial stability of the United States.

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Implementation of the "Volcker Rule"

- The agencies should consider how to handle investments made by foreign insurance companies and determine under what circumstances such investments would be considered permitted activities.

- The agencies should consider whether separate account investments should be treated as being made on behalf of customers, another permitted activity under the Volcker rule.

- The agencies should examine whether the definition of "hedge fund" and "private equity fund" precludes the sale of certain insurance products that were not intended to be limited by the Volcker rule.

- The banking regulators, the Securities Exchange Commission, and the Commodity Futures Trading Commission must now consider the FSOC study and are charged with promulgating rules within 9 months – so by mid-October. The NAIC continues to closely monitor this issue.

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Concentration Limits on Large Firms

- DFA imposes concentration limits on:
  - insured depository institutions;
  - Bank holding companies;
  - A savings and loan holding companies;
  - A company that controls an IDI;
  - A non-bank financial company supervised by the Fed (including certain insurers);
  - a foreign bank or company that is treated as a bank holding company;
- These entities may not merge, consolidate with, or acquire another company, if the total consolidated liabilities of the acquiring company upon consummation of the transaction would exceed 10% of the aggregated consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction.

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Concentration Limits on Large Firms

- The Fed has authority to implement these limits by rule. It is specifically charged with defining the term "liabilities" as applied to relevant insurance companies (non-bank systemically risky insurers) for the purpose of implementing this concentration limit.

- The Fed is required to define this term in a way that ensures the equitable and consistent treatment of such insurers (or other non-bank financial institutions).

- Per the provisions of DFA, FSOC issued a study on such limits on January 18, 2011 finding generally that moral hazard will be reduced and financial stability will generally be enhanced by the imposition of such limits.

- The Fed is required to finalize rules in nine months implementing this concentration limit.

Resolution

- FSOC can recommend to the Fed regarding the requirement that each non-bank company supervised by the Board submit a plan detailing the plan for resolving the company in the event of material financial distress or failure.

- FSOC must make recommendations to the FDIC on the risk matrix to be used to determine the extent of the assessments imposed on non-bank financial companies supervised by the board and bank holding companies in excess of 50 billion in consolidated assets.

  – Such assessments are to be used to resolve a systemically important institution under Title II.

  – In developing this risk matrix, the Council and FDIC is supposed to take into account guaranty fund assessments.

  – It is anticipated that recommendations will be made this year

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Resolution

- State regulators continue to work closely with the Federal Deposit Insurance Corporation (FDIC) as it develops the authority to wind down systemically risky entities.

- If an insurance company or subsidiary deemed systemically risky is to be wound down, it would be rehabilitated or liquidated pursuant to state law.

- However, if no action has been taken within 60 days after the determination of risk, the FDIC has the authority to step in and take the matter
over from the state insurance commissioner.

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Office of Financial Research (OFR)

- Dodd-Frank also created the Office of Financial Research (OFR) and we are currently examining how this office may affect state regulation and how it could interact with the FIO and NAIC.

- The OFR was created under the Dodd-Frank Act to support the activities of the FSOC, standardize reporting processes, develop a reference database, maximize data efficiency and security in coordination with agencies and regulators and regularly report to Congress.

- OFR has been working to simplify the current process of tracking counterparties to derivatives transactions. In this last assignment, in particular, we understand that some lobbyists are beginning to call the OFR the potential "CIA of financial regulators."

Office of Financial Research (OFR)

- Under Dodd-Frank OFR will have the power to request, and then subpoena, financial information from financial institutions deemed "systemically risky" and therefore under supervision by the Federal Reserve. It also may require information from other financial or bank holding companies to determine Systemic importance.

- The OFR is currently focusing on the promulgation of regulations that will standardize the reporting of information related to derivatives - specifically, working with industry to develop "Legal Entity Identifiers," or LEIs, that will be used to trace ownership of various complicated swap positions to their sources.

- The OFR does not yet have a director nominated by President Obama. We have reached out to their office - have not heard back yet. We will continue to monitor the activities of this office as it collects data, issues regulations and supports FSOC and its members.

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Consumer Financial Protection Bureau (BCFP) (Title X)

- During negotiations on Dodd-Frank, NAIC worked with House and Senate supporters to insert a provision into Title X (regarding the BCFP) that defines the business of insurance as:

  "the writing of insurance or the reinsuring of risks by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons."

- Title X excludes the business of insurance from the "financial products and services" that fall under the BCFP's purview.

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Questions???