LLB&L Client Alert

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Financial Regulatory Reform - Impact on Insurance Industry

The Treasury Department's proposal for the most significant financial regulatory overhaul since the Great Depression was released on June 17, 2009, in a white paper entitled Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (the "Plan"). The Plan calls on Congress and regulators to adopt measures ranging from establishment of stronger supervision of financial firms to creation of an entirely new agency designed to protect consumers. An executive summary, fact sheets and a complete copy of the 88-page Plan are available at http://www.treasury.gov/initiatives/regulatoryreform. In this *Client Alert* we focus on the impact the Plan may have on the insurance industry. Because many of the Plan's proposals are conceptual it is not possible to predict with any certainty whether or how any particular aspect of the Plan might be implemented.

I. Regulation of Systemically Important Financial Firms

A. Identification and Regulation of Tier 1 Financial Holding Companies

Any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it fails (a "Tier 1 FHC") would be subject to supervision and regulation by the Federal Reserve (the "Fed"), regardless of whether the firm owns an insured depository institution. The Plan recognizes this could include insurance holding companies. Supervision of a Tier 1 FHC would extend to the parent company and to all of its subsidiaries, regulated and unregulated, U.S. and foreign. Treasury Secretary Geithner's testimony in March and April 2009 before the House Financial Services Committee and Congressional Oversight Panel signaled his view that federal authorities should have the ability to regulate subsidiary insurance companies if they pose a potential risk to the financial system. The Plan also seeks to raise international regulatory standards and in doing so advocates that the Treasury, in consultation with the Fed, develop rules to guide the identification of foreign financial firms as Tier 1 FHCs based on whether their U.S. operations pose a threat to financial stability.

(i) Financial Services Oversight Council

The Fed would be assisted in identifying Tier 1 FHCs by a new Financial Services Oversight Council (the "Council"). The Council would have eight members, one member from each of the principal federal financial regulators with the Secretary of the Treasury serving as Chair. Neither the proposed Office of National Insurance ("ONI") discussed below nor state insurance regulators would have a position on the Council. In the case of an entity that has one or more subsidiaries subject to prudential regulation by other federal regulators, the Fed would be required to consult with those federal regulators before classifying the firm as a Tier 1 FHC. There is no similar requirement that the Fed consult with the ONI or state insurance regulators before classifying an insurance holding company as a Tier 1 FHC.

The Council would help facilitate the coordination of policy, resolve disputes between regulators, and identify emerging risks in firms. Without an insurance regulatory representative on the Council, the insurance industry could be at a disadvantage when the Council is forced to resolve jurisdictional disputes involving insurance companies. The Council would also have broad authority to gather information from any financial firm to identify emerging risks to financial stability, and would have the authority to examine and collect periodic and other reports from all U.S. financial firms that meet certain minimum size thresholds to determine if they should be regulated as Tier 1 FHCs.

(ii) Regulation of Tier 1 FHCs

The Plan contemplates providing the Fed with significant regulatory authority over Tier

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1 FHCs and their subsidiaries. While functionally regulated Tier 1 FHCs and their insurance company subsidiaries would continue to be supervised and regulated primarily by their functional regulators, the authority proposed for the Fed would add an additional layer of oversight and more stringent requirements which include the following:

- *Capital Requirements and Liquidity Standards*
- *Overall Risk Management*
- *Market Discipline and Disclosure*
- *Prompt Corrective Action*
- *Rapid Resolution Plans*
- *Restrictions on Non-financial Activities*. Tier 1 FHCs that do not control insured depository institutions would be subject to the full range of prudential regulations and supervision applicable to bank holding companies. Each Tier 1 FHC also would be required to comply with the restrictions of the Bank Holding Company Act on non-financial activities by divesting its non-financial commercial operations, regardless of whether it controls an insured depository institution. Tier 1 FHCs that have not been previously subject to the Bank Holding Company Act would be given five years to comply. These restrictions on non-financial activities could raise significant issues for holding companies which include both insurance and non-financial commercial subsidiaries. These holding companies would, in effect, be forced to choose between their insurance and non-financial commercial operations.
- *Examination*. The constraints of the Gramm-Leach-Bliley Act which limit the Fed's ability to require reports from, examine, or impose higher requirements on the functionally regulated or depository institution subsidiaries of all financial holding companies (not just Tier 1 FHCs) would be removed.

(iii) Regulation of Non-Insurance Affiliates

AIG's difficulties have clearly focused Treasury on the need for more effective regulation of non-insurance companies within insurance holding company systems. Insurance regulators have the authority under the National Association of Insurance Commissioners ("NAIC") Holding Company System Regulatory Act ("Model Act") to examine the books and records of non-insurance affiliates, including the non-insurance parent company. The NAIC has on several occasions considered whether insurance regulators should have expanded authority over non-insurance holding company parents and their non-insurance subsidiaries. But the Model Act has not been revised because the NAIC concluded that state regulators already have the tools necessary to police transactions that could potentially undermine the solvency of the insurance subsidiaries which are their primary focus. However, the AIG example has called into question whether insurance regulators adequately monitored the potential impact the AIG parent problems could have on its insurance subsidiaries.

The NAIC has established a Group Solvency Issues Working Group ("Working Group") to study potential revisions to the Model Act that would address systemic issues within insurance holding company systems. The Working Group is studying the need to develop group-wide supervision which may include group-wide capital requirements and possible broad regulation of non-insurance affiliates. While the NAIC continues to study the issue, the state regulators' hands off approach concerning the AIG parent may illustrate the states do not have the ability to monitor and regulate systemic problems within an insurance holding company system. If so, the responsibility for doing so will default to the Fed or some other federal regulator as proposed in the Plan.

B. Resolution Regime

The Plan would create a resolution regime for Tier 1 FHCs if a disorderly resolution would have serious effects on the economy or financial system. The federal government's responses to Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of non-bank financial firms. The Plan proposes a formal process, initiated by the Treasury or Fed (although the FDIC and SEC could also initiate in specified instances), for deciding whether use of this special resolution regime is necessary for a particular firm. The Treasury would only invoke this authority in extraordinary cases after consulting with the President and obtaining approval from the Fed and FDIC. If the failing firm includes an insurance company, the newly created ONI (discussed below) would provide consultation to the Fed and FDIC on insurance specific matters. It is not clear whether the Plan envisions an insurance subsidiary coming under this resolution procedure in the event its parent becomes subject to this resolution regime. If so, the resolution regime would apparently conflict with state insurance code liquidation and receivership provisions applicable to the insurance subsidiaries. This raises numerous issues involving the orderly conservation, rehabilitation or liquidation of the insurance subsidiaries

that need to be carefully considered by the drafters of any proposed enabling legislation. The Plan contemplates that existing consumer protections provided to insurance policyholders under federal and state law (this would likely include insurance guaranty funds) would be maintained under the Plan.

C. Unprecedented Fed Powers

The decision to name the Fed as the risk regulator is not without its critics. Some believe the Fed to be partly responsible for the current financial crisis in its failure to adequately regulate subprime mortgages and other loans which helped cause the current crisis. The Chair of the Senate Banking, Housing and Urban Affairs Committee quoted a former Fed examiner at a recent hearing stating that "giving the Fed more responsibility at this point…is like a parent giving his son a bigger…faster car right after he crashed the family station wagon." In addition, the Fed has historically been independent, and some believe its new role as overall risk regulator with such close ties to the Treasury might compromise its independent status.

II. Office of National Insurance & Modernization of the Insurance Industry Regulation

A. Office of National Insurance

While providing no specific directions for modernizing insurance regulation, the Plan notes that the current state regulatory system is inefficient, costly and is an obstacle to product innovation. Recognizing the importance of the insurance industry to the national economy, the Plan calls for the establishment of the ONI within the Treasury to coordinate policy in the insurance sector. One power of the ONI particularly worth noting is its proposed authority to enter into international agreements and increase international cooperation on insurance regulation. The authority of the ONI to enter into international agreements could have broad reaching consequences. The ONI could conceivably preempt state insurance law if it decides to enter into international agreements. There is no requirement in the Plan that the ONI consult state insurance regulators or the NAIC before entering into these international agreements.

The ONI would also recommend to the Fed any insurance companies that it believes should be supervised as Tier 1 FHCs.

While the Plan underscores the importance of modernizing the insurance regulatory framework and sets out the following six principles for modernizing the insurance industry, it provides little detail on precisely how these broad principles will be implemented:

- Effective systemic risk regulation with respect to insurance;
- Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies;
- Meaningful and consistent consumer protection for insurance products and practices;
- Increased national uniformity through either a federal charter or effective action by the states;
- Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business; and
- International coordination.

B. Implications for an Optional Federal Charter

What may be most notable regarding the principles outlined above is what is not explicitly required: A national insurance regulator in the form of an optional federal charter. See our April 8, 2009, *Client Alert* entitled Once More Into the Fray: National Insurance Consumer Protection Act Revives Optional Federal Charter Discussion for a discussion of the issues raised by optional federal charter legislation. Opposition from many state insurance regulators and diverging viewpoints within the insurance industry may have resulted in the Obama Administration abandoning the optional federal charter as an explicit requirement of the Plan. However, it is clear from the principles outlined in the Plan that the Obama Administration and the Treasury are of the view that the time for significant change and action at the state level has arrived. This modernization effort, therefore, could ultimately lead to optional federal charter legislation as Treasury Secretary Geithner indicated in his March 2009 testimony.

III. Creation of a New Consumer Financial Protection Agency

The Plan proposes to create a new Consumer Financial Protection Agency ("CFPA") dedicated to protecting consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or Commodities Futures Trading Commission ("CFTC"). Significant aspects of the CFPA are:

- *Covered Products*. The CFPA would seek to protect consumers of credit, savings, payment, and other consumer financial products and services and regulate providers of such products and services. Once legislation is drafted creating the CFPA, the new agency would likely have the power to determine which products would be eligible for regulation (however, as noted above, it would not have authority over investment products and services already regulated by the SEC or CFTC). Whether and which insurance products would be regulat-

ed under the CFPA may not be known until the legislation is drafted and quite possibly until the CFPA begins its rulemaking process. However, it appears the Obama Administration may envision certain annuities falling under the jurisdiction of the CFPA in light of Secretary Geithner's and Lawrence Summers' recent comments that the crisis has revealed the "inadequacy of consumer protections across a wide range of financial products — from credit cards to annuities." We will closely watch the Congressional hearings and other developments regarding the CFPA to determine the likely impact on the insurance industry.

- *Independent Agency*. The CFPA would be an independent agency with funding that could come in part from fees assessed on transactions and firms across the financial sector, including bank and non-bank institutions and other providers of covered products and services.

- *Sole Rulemaking Authority*. The CFPA would have sole rule-making authority for consumer financial protection statutes.

- *Supervisory and Enforcement Authority.* The CFPA would have supervisory, examination and enforcement authority over all entities subject to its regulations.

- *States Would Retain Authority*. The CFPA's rules would serve as a floor, not a ceiling, as states would have the ability to adopt and enforce stricter laws. States could also enforce compliance with both federal and state law.

- *Federal Trade Commission ("FTC").* The FTC's primary authority for financial product and services protections would be transferred to the CFPA, with the FTC retaining backup authority to the CFPA for the statutes for which the FTC currently has jurisdiction.

- *Reform*. The Plan also proposes a series of recommendations for legislation, regulations, and administrative measures to reform consumer protection based on principles of transparency, simplicity, fairness, accountability, and access for all consumers.

IV. Comprehensive Supervision of Financial Markets

The Plan proposes to enhance regulation of securitization markets, provide stronger regulation of credit rating agencies, and require that issuers and originators retain a financial interest in securitized loans. The Plan also standardizes OTC derivative transactions (in particular, credit default swaps ("CDS")) by having them regulated in transparent venues and cleared through regulated central counterparties.

The Plan also comes out in support of a Financial Accounting Standards Board proposal to amend Generally Accepted Accounting Principles to eliminate the immediate recognition of gain on sale by originators at the inception of a securitization transaction and instead require originators to recognize income over time. In addition, the Plan favors having many securitizations consolidated on the originator's balance sheet and their asset performance reflected in the originator's consolidated financial statements.

V. Consolidation of the OTS and OCC into a New Federal Agency and Elimination of Thrift Charters

A newly created federal agency (termed National Bank Supervisor ("NBS")) would assume the prudential responsibilities of the Office of the Comptroller of the Currency ("OCC"), which currently charters and supervises nationally chartered banks and federal branches and agencies of foreign banks, and the Office of Thrift Supervision ("OTS"), which supervises federally chartered thrifts and thrift holding companies. The Plan would also eliminate the federal thrift charter.

The OTS is the chief regulator of a number of holding companies with well-known insurance subsidiaries, including AIG. Those insurance groups should be cognizant that under the Plan they would be subject to a new regulator which would bring with it a host of regulatory uncertainties, including how aggressive the new regulator would push to regulate the operations of the insurance affiliates of the holding company. Given the problems at AIG we expect there to be more pressure on the NBS to regulate not just banking subsidiaries, but also non-banking subsidiaries, including insurance companies. We will continue to follow closely the drafting of this legislation and the rules that are promulgated to determine the potential impact this new regulator will have on the insurance subsidiaries of current OTS holding companies.

VI. Outlook

While some measures of the Plan could be adopted by existing regulatory agencies without Congressional action, most significant elements of the Plan will require legislative action by Congress. The questions posed to Secretary Geithner during his testimony to Congress after the unveiling of the Plan indicate that Congress will not simply accept the Plan without debate and probable changes. In addition, many parts of the Plan, including those calling for the modernization of insurance, are broad principles leaving significant detail to those that ultimately draft and implement the new laws.

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Financial Regulatory Reform - Impact on Insurance Industry (cont'd.)

Some in Congress are critical of the Plan for leaving the state insurance regulatory infrastructure in place as well as the alphabet soup of federal agencies and not undertaking a complete overhaul of the regulatory system. Others are calling for a complete evaluation of the Plan including a close examination of the facts upon which the recommendations were made. Many have questioned the decision to name the Fed as the systemic risk regulator and also regret the last time the Treasury demanded quick action, believing the Troubled Asset Relief Program ("TARP") was not adequately considered, thus resulting in inadequacies in the legislation. With other significant items on the legislative agenda, including comprehensive health care and energy reform, we expect Congress to act more deliberately in drafting, debating and passing legislation on these complex issues. Nevertheless, the momentum for financial regulatory reform, including reform of the insurance industry, is strong. The overwhelming view is that changes to our financial regulatory system need to be made, and the insurance industry will not be immune to such action. Locke Lord Bissell & Liddell will continue to be involved in following and tracking all developments in this fast moving area.

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