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Dodd-Frank: The Road Ahead

Insurance

Federal Insurance Regulation

Federal Regulation of Insurance: Recent Developments



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As the result of the fierce, often partisan, debate in the U.S. among pundits, interest groups, political parties, financial regulators, Congressmen, President Obama and his administration, and Republican candidates for President over taxation and initiatives to increase economic growth, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] remains controversial. Dodd-Frank has been a lightning rod for both the left and the right about the causes of the financial crisis in 2008-2009. Arguments over whether Dodd-Frank was an appropriate step to increase the stability of our financial system or whether its implementation will unnecessarily hinder economic recovery will undoubtedly continue through the next presidential election and beyond. Much of the criticism and support for Dodd-Frank relates to its new approach to the regulation of commercial and investment banking and the securities markets. Yet, very little discussion of Dodd-Frank's specific impact on the U.S. insurance industry has received prominent play in the debate over the repeal and implementation of Dodd-Frank, in whole or in part.

The inattention to aspects of Dodd-Frank that are directed towards insurers and reinsurers is understandable given that less than 5 percent of Dodd-Frank addresses the regulation of insurance and reinsurance as distinct business activities. However, the adoption of Dodd-Frank and the implementation of its provisions presents the latest arena for the decades-long argument over the merits of state versus federal regulation of insurance.

During the financial crisis of 2008-2009, some commentators suggested that Congress had an opportunity to increase the federal regulatory role over insurance and sweep the insurance industry into Dodd-Frank. However, despite early calls for broad federal regulation of insurance companies and the repeal of the McCarran-Ferguson Act[2] by some, Congress did not overturn, or even significantly change, state regulation of the insurance industry. This fact points to Congress's implicit acknowledgment that during the financial crisis, state-regulated insurers fared far better than other pillars of the financial services industry.

Dodd-Frank's Insurance-Related Provisions

Thus, Dodd-Frank left the question of increased federal regulation of insurance largely for a later day. While important, the modest changes effected were not direct assaults on the system of state regulation of insurance. These changes included:

- the establishment of the Federal Insurance Office (FIO);[3]

- simplification of the operations of the nonadmitted market by providing for single state regulation and taxation of surplus lines placements, streamlined placements for large commercial insureds, and harmonization of criteria for eligibility of surplus lines insurers;[4] and
- restrictions on nondomiciliary states from imposing more stringent requirements on insurers as to credit for reinsurance than are imposed by their domiciliary states.

The Scope of FIO's Role

The appointment of Michael T. McRaith as the FIO's director appears to have allayed initial industry concerns regarding the breadth of the FIO's statutory functions and the possibility that the FIO and its staff might not appreciate the resiliency and unique characteristics of the U.S. insurance industry when compared to other financial service companies. During a hearing on October 25, 2011 before the House Subcommittee on Insurance, Housing and Community Opportunity, Director McRaith attempted to allay those concerns, stating, "[t]he FIO will consult and work closely with the state insurance departments, which remain the functional regulators over the business of insurance, as we develop federal insurance policy on insurance matters."[5] He further testified that:

> [a]s required by the statute, we will request information only if that information is not already available from public sources, a federal agency, or a state regulator. We will also coordinate with the Office of Financial Research to reduce reporting burdens by avoiding unnecessary or redundant data requests.

Contrasting this statement was the FIO's and the Office of Financial Research's (OFR) subpoena power over insurance companies granted by Dodd-Frank. However, legislation is pending that could remove this power. On December 8, 2011 the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity approved legislation eliminating the FIO's and the OFR's authority to subpoena information from insurance companies. H.R. 3559 (the Insurance Data Protection Act), was introduced by Representative Steve Stivers (R-OH) and was approved by a party-line vote of 7-5, with each Republican on the Subcommittee voting in favor.

The legislation still needs to be approved by the House and Senate; however, the Subcommittee's approval is perceived as a step in the right direction by those in the insurance industry who have expressed concern over encroaching federal regulation, typically reserved for the states. Despite these concerns, or in light of them, the FIO continues to reaffirm its deference to state regulation. On December 9, 2011, the FIO held its first meeting at the U.S. Department of Treasury, entitled "Insurance Regulation in the United States: Modernization and Improvement." The conference was attended by insurance regulators and industry representatives. During the meeting, a clear message was that the role of the FIO should be informational and yield to state regulation. As Deputy Treasury Secretary Neal Wolin told the crowd of about 200, "It is not the role of the FIO to regulate the insurance industry. That job belongs to the states." State regulators will be important partners to the U.S. Treasury Department as the Federal Insurance Office moves forward on its work, said the Deputy Treasury Secretary, adding that "nothing in the Dodd-Frank Act alters the fact that insurance is fundamentally regulated by the states."[6]

The meeting precedes a report due January 2012, as mandated by Dodd-Frank. This conference came amidst a series of almost forty meetings with insurance regulators, trade associations, and consumer groups McRaith is having that will also help shape the mandated report. The report is widely anticipated as an insight into how the FIO plans to use its authority and is discussed in more detail below.

FIO's Report to Congress

Recently, the FIO has offered a public statement as to the scope of its report to Congress on modernizing and improving the regulation of insurance that is due in January 2012. In a notice published on October 17, 2011,[7] the FIO requested comments on this study on a dozen topics including:

- Systemic risk regulation with respect to insurance;
- Degree of national uniformity of insurance regulation;
- Feasibility of federal regulation of only certain insurance lines;
- Ability of federal regulation or regulators to eliminate regulatory arbitrage; and
- Potential consequences of subjecting insurers to federal resolution authority.

Public comments on the FIO's report were due by December 16, 2011.

This report may well shape the debate over the need for federal regulation of insurance for years to come. While Director McRaith, based on his personal experience, may be able to attest to the efficacy of state regulation of insurers, the report may review and discuss increased federal involvement in the insurance business, including the ability of consumers and businesses to purchase insurance across state lines, and the merits of an optional federal charter. The insurance industry will likely scrutinize the report for indicators of erosion of state regulation and evidence that Director McRaith's sentiments regarding the FIO's limited authority will carry through in this report.

FSOC Designation of Insurers and Reinsurers as SIFIs

Insurance and reinsurance companies may be subject to federal regulation as systemically important financial institution (SIFI). Under Dodd-Frank, insurers and reinsurers doing business in the U.S. are "nonbank financial companies" and, therefore, may be designated as SIFIs. If an insurer or reinsurer is determined to be a SIFI, it will be subject to federal, as well as state, regulation.

On July 22, 2011,[8] the Financial Stability Oversight Council (FSOC) approved its first annual report, as mandated by Dodd-Frank. In the report, which focused on the current state of the U.S. financial system and steps to be taken to strengthen it, FSOC also discussed the status of the establishment of criteria for identifying nonbank financial companies that are SIFIs. On October 11, 2011, FSOC issued a notice of proposed rulemaking and proposed interpretive guidance as to the determination of nonbank financial companies that are SIFIs.[9]

Under the proposed regulations and guidance, FSOC will undertake a three-stage process to determine if a nonbank financial company is a SIFI. In Stage 1, FSOC will analyze all nonbank financial companies with consolidated assets of $50 billion or more and determine if one or more of the following thresholds is also met:

- Notional credit default swaps equal or exceed $30 billion;
- Net derivative liabilities equal or exceed $3.5 billion;
- Loans and bonds outstanding equal or exceed $20 billion;
- Leverage ratio is more than 15 to 1; and/or
- Short-term debt equals or exceeds 10 percent of total consolidated assets.

In Stage 2, potential SIFIs identified in Stage 1 will be subject to a "robust analysis of the potential threat"[10] posed by a failure of the nonbank financial company to U.S. financial stability.

Finally, in Stage 3, if FSOC determines that a potential threat could be posed under a Stage 2 analysis, FSOC will notify the nonbank financial company that it is under consideration as a SIFI and review additional information, including information provided by the nonbank financial company, before making a final determination. FSOC may make a SIFI designation by a two-thirds vote. Note that a nonbank financial company that is notified that FSOC is considering designating it to be a SIFI will have a right to request an FSOC hearing on the matter. Section 113(h) of Dodd-Frank permits a nonbank financial company to seek rescission of a SIFI designation before a U.S. district court. However, the bar for recission is set high as the sole standard of review is limited to whether FSOC's determination was arbitrary and capricious.

FSOC invited public comments on its proposed rule relating to nonbank SIFIs by December 19, 2011. During a meeting between FSOC staff and representatives of the American Insurance Association (AIA) to discuss comments from the AIA, AIA raised some concerns about the Stage 1 review process as applied to insurers and reinsurers including the notional credit default swap criteria. AIA also suggested that a market concentration metric might be useful in the Stage 1 process and noted the importance of coordinating with global efforts to regulate the insurance and reinsurance industry.

Notably, the respective roles of state and federal regulators of insurers or reinsurers that are SIFIs were not extensively considered in FSOC's notice.

Appointment of FACI Members

Another recent development is the appointment of fifteen members to the Federal Advisory Committee on Insurance (FACI) on November 2, 2011. FACI was created by the Department of the Treasury pursuant to 31 U.S.C. § 313(h)[11] and will serve as an advisory council to the FIO. Seven of the FACI members are insurance regulators, with the balance made up of representatives of academia, insurance service providers, insurance producers, insurance and reinsurance companies and consumer advocates. The exact role that FACI will play in the FIO's report to Congress discussed above has not been specified.

Will the Picture Become Clearer in 2012?

Almost a year and a half has passed since the adoption of Dodd-Frank, yet a clear scheme for future federal involvement in insurance regulation is still being developed. However, in the first quarter of 2012, the picture may become clearer when the FIO issues its report on modernizing the regulation of the insurance industry, and if FSOC takes further action on defining nonbank SIFIs. In addition, the states' responses to limits on their ability to regulate the surplus lines market is still in flux and legal challenges by insurers, producers, and consumers to regulation arguably in conflict with Dodd-Frank may be in the offing.

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[1] Pub. L. 111-203 (2010)

[2] 15 U.S.C. §§ 1011-1015

[3] Among the FIO's statutory functions are:

- monitoring all aspects of the industry, including identifying any aspects of insurance regulation that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
- recommending to the Financial Stability Oversight Council that an insurer and its affiliates be subject to regulation as a nonbank financial company by the Federal Reserve Board of Governors;
- by the end of January 2012, reporting to Congress on how to modernize and improve the system of insurance regulation in the United States; and
- coordinating and developing federal policy on international insurance issues, including assisting the Secretary of the Treasury in negotiating international agreements on insurance or reinsurance.

[4] Many states have modified their laws and regulations to accommodate these provisions of Dodd-Frank, which are contained in the portion of Title V denominated the "Nonadmitted and Reinsurance Reform Act," including enabling legislation allowing them to join one of the two competing compacts for allocation and distribution of surplus lines premium taxes, although a few states have decided to simply retain 100 percent of the tax.

[5] *Insurance Oversight: Policy Implications for U.S. Consumers, Businesses and Jobs, Part 2: Hearing Before the House Committee on Financial Services Subcommittee on Insurance, Housing and Community Opportunity,* 112th Cong. (2011) (written testimony of Michael T. McRaith, Director of the Federal Insurance Office).

[6] *Remarks by Deputy Secretary Neal Wolin Federal Insurance Office Conference, "Insurance Regulation in the United States: Modernization and Improvement"* (U.S. Dep't of the Treasury Dec. 9, 2011).

[7] 76 Fed. Reg. 64174 (October 17, 2011)

[8] 2011 Fin. Stability Oversight Council Ann. Rep., *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf.

[9] 76 Fed. Reg. 64264 (October 18, 2011)

[10] *Id.*

[11] 76 Fed. Reg. 28129 (May 13, 2011)