The Impact on the Insurance Industry of the Financial Regulatory Reform Bills: A Legislative Update

June 7, 2010

On May 20, 2010, the U.S. Senate passed a comprehensive set of financial regulatory reforms that, if enacted, will represent the most sweeping set of changes to the U.S. financial regulatory system since the Great Depression. The reforms, which are set forth in a bill of more than 1,500 pages called the Restoring American Financial Stability Act of 2010 (S. 3217, or the "Senate Bill") and which come after nearly a year of Congressional hearings and months of stop-and-start legislative negotiations, contain a number of provisions relevant to the insurance industry.

In its treatment of the insurance industry, the Senate Bill tracks many of the themes contained in the Wall Street Reform and Consumer Protection Act (H.R. 4173, or the "House Bill") that was passed by the U.S. House of Representatives (the "House") on December 11, 2009. This memorandum reviews the principal provisions of the Senate and House Bills applicable to the insurance industry. Congress will now attempt to reconcile the differences in the Senate and House Bills, on this and other matters, through a formal conference committee process that is expected to culminate in legislation being approved by Congress and submitted to the President for his signature in early July.

A. FEDERAL OFFICE OF INSURANCE

The Senate and House Bills each create a new federal office of insurance (the "FOI") to be located within the U.S. Department of the Treasury (the "Treasury") and headed by a director (the "Director") appointed by the Treasury Secretary.[1]

Powers and Functions

Pursuant to the direction of the Treasury Secretary, and in addition to other powers and functions assigned to it by the Treasury Secretary, the FOI will have the following powers and functions:

- To monitor all aspects of the insurance industry;
- To identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;

[1] The FOI is named the "Office of National Insurance" in the Senate Bill and the "Federal Insurance Office" in the House Bill.

- To monitor the extent to which traditionally underserved communities and consumers have access to affordable insurance products (House Bill only);
- To recommend to the Financial Stability Oversight Council (the "Council") that it designate an insurer as an entity to be subject to stricter standards[2] (the House Bill) or as a nonbank financial company to be supervised by the Board of Governors of the Federal Reserve[3] (the "Federal Reserve") (the Senate Bill);
- To assist in administering the Terrorism Insurance Program;
- To coordinate federal policy on international insurance matters and represent the U.S. in the International Association of Insurance Supervisors; and
- To determine whether state insurance measures are preempted by international agreements.

The scope of these powers and functions extends to all lines of insurance except health insurance. To carry out these functions, the FOI would have the power to require an insurer, or any affiliate of an insurer, to submit any data or information it may reasonably require. However, the FOI must first coordinate with other relevant regulators to determine whether information is otherwise available before requiring it to be provided. In addition, the FOI may enter into information-sharing agreements with state insurance regulators, analyze and disseminate data and information, and issue reports regarding all lines of insurance (except health insurance).

Preemption

The House and Senate Bills authorize the FOI to preempt any state insurance measure to the extent it is inconsistent with an international insurance agreement or results in less favorable treatment to a non-U.S. insurer that is subject to such an agreement than to a U.S. insurer

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[2] Under the House Bill, the Council may subject a financial company (including an insurance company) to stricter standards if the Council determines that material financial distress at the company could pose a threat to financial stability or the economy or that the nature, scope, size, scale, concentration and interconnectedness of the company's activities could pose a threat to financial stability or the economy. To do so, the Council must consult with the relevant agency that regulates the company and consider, among other things, the degree of leverage of the company, the amount and nature of its financial assets, the amount and types of its liabilities, the extent and types of its off-balance sheet exposures, and the extent and types of its transactions and relationships with other significant nonbank financial companies and bank holding companies. Companies subject to stricter standards are subject to Sections 4, 5(b)-(g) and 8 of the Bank Holding Company Act of 1956, Section 8 of the Federal Deposit Insurance Act, and a leverage limitation of 15 to 1.

[3] Under the Senate Bill, the Council, by a vote of no fewer than 2/3 of its members, including an affirmative vote of the chairperson, has the authority to require that any company substantially engaged in activities that are financial in nature (as defined in Section 4(k) of the Bank Holding Company Act of 1956) be supervised by the Federal Reserve and subject to prudential standards if that company may pose risks to the financial stability of the U.S. in the event of its material financial distress or failure. The factors to be considered by the Council are substantially similar to those set forth in the House Bill. Nonbank financial companies supervised by the Federal Reserve must register with the Federal Reserve and submit reports (as deemed necessary by the Council) to the newly established Office of Financial Research. In addition, after enactment, the Federal Reserve will establish prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Federal Reserve and bank holding companies.

domiciled or licensed in that state. To do so, the FOI must first notify and consult with the relevant state regulator and engage in a notice and comment process with potentially interested parties.

Importantly, the FOI explicitly is not provided with general supervisory or regulatory authority over the business of insurance (i.e., dealings between insurers and policyholders).

Reporting to Congress

The Senate Bill contains a provision not included in the House Bill that requires the Director to conduct a study and submit to Congress within 18 months of enactment a report on how to modernize and improve insurance regulation in the U.S. This report must consider, among other things, systemic risk regulation with respect to insurance, and must examine, among other things, the costs and benefits of potential federal regulation of the insurance industry, the ability of federal regulation to minimize regulatory arbitrage, and the ability of federal regulation to provide robust consumer protection for policyholders. In addition, both the House and Senate Bills require the Director to submit an annual report to Congress on the insurance industry, any FOI actions taken to preempt state insurance measures, and any other information deemed relevant by the Director.

B. STATE-BASED INSURANCE REFORM

The Senate Bill's version of the Nonadmitted and Reinsurance Reform Act (the "NRR") is substantially identical to the version included in the House Bill, which was originally passed unanimously by the House on September 9, 2009 and subsequently referred to the Senate Committee on Banking, Housing and Urban Affairs. The NRR is primarily designed to streamline the regulation of reinsurance and nonadmitted insurance, which is property or casualty insurance permitted to be placed from an insurer not licensed to engage in the business of insurance in a state but otherwise eligible to accept such insurance.

Nonadmitted Insurance Provisions

The NRR limits regulation of the placement of nonadmitted insurance solely to the home state of the insured. In addition, the NRR (a) prohibits states other than the home state of the insured from requiring any premium tax payment for nonadmitted insurance; (b) encourages states to enter into a nationwide compact to establish procedures for payment, collection and allocation of such premium taxes for nonadmitted insurance; (c) prohibits states from imposing eligibility requirements on nonadmitted insurers domiciled in the U.S. except in conformance with the National Association of Insurance Commissioners (the "NAIC") model law; (d) prohibits states from disallowing surplus lines brokers from placing insurance from non-U.S. nonadmitted insurers who are included on the NAIC list; (e) prohibits states, other than an insured's home state, from requiring a surplus lines broker to be licensed in order to sell nonadmitted insurance; and (f) requires the Comptroller General to conduct a study to determine how enactment of the NRR affected the size and market share of the nonadmitted insurance market for providing coverage typically provided by the admitted insurance market. In addition, the NRR substantially softens the requirement with regard to large commercial policyholders that a surplus lines broker must first attempt to place coverage in the admitted market.

Reinsurance Provisions

Under the NRR, if the domiciliary state of a ceding company is NAIC-accredited or has financial solvency requirements substantially similar to those required for NAIC accreditation, then no other state may deny credit for reinsurance for the ceded risk if the domiciliary state recognizes such credit for reinsurance. Moreover, if the domiciliary state of a reinsurer is NAIC-accredited or has financial solvency requirements substantially similar to those required for NAIC accreditation, then that state shall be solely responsible for regulating the financial solvency of the reinsurer and no other state may require the reinsurer to provide financial information other than that information provided to the domiciliary state.

C. MISCELLANEOUS PROVISIONS

Other key highlights of the bills include the following:

- In the Senate Bill, one member of the Council must be an independent member with insurance expertise named by the President and confirmed by the Senate.
- In the House Bill, one non-voting member of the Council must be the Director of the FOI, and another non-voting member of the Council must be a state insurance commissioner.
- In the Senate Bill, insurance company subsidiaries of companies defined as Financial Companies for purposes of the new orderly liquidation authority, which is modeled largely on the FDIC's resolution authority for insured depository institutions, are themselves excluded from the new liquidation authority.
- In both the Senate and House Bills, persons regulated by a state insurance regulator are carved-out from the authority of the Consumer Financial Protection Agency.

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For more information about the Senate and House Bills and the implications for the insurance industry, please contact any of the members of the Firm's Insurance and Reinsurance Group.

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