




Update On Federal Insurance Reform
November 10, 2010 Casualty Actuarial Society General Session

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DFA – It's Not Just For Actuaries Anymore

The Dodd-Frank Act and Its Effect on Insurers

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 PCI
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 November 10, 2010

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Outline of Comments

- Evolution of Federal Insurance Regulation Legislation
- Dodd-Frank Act (DFA) Summary and Impact on Insurers
- Future Insurance Regulation

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A Creature of the Global Financial Crisis

- Many attempts to enact federal insurance legislation during the 1990s and the 2000s
- None had enough consensus support to cross the finish line
- Creation of a Federal Insurance Office (FIO) was an adjunct to much broader financial reform legislation, triggered by the greatest financial panic since the Great Depression

Dodd-Frank Act PCI's Clear Message: Don't Fix What Isn't Broken

- Home, auto, and business insurance didn't cause the crisis
- Stable and healthy despite the recession and the 4th largest hurricane losses in history
- Didn't ask for federal money
- Not systemically risky
- Solvency regulation has worked well
- **We don't need duplicative federal regulation to fix something that isn't broken**

Summary of DFA

- 2,307 pages
- Financial Stability Oversight Council = college of federal regulators
 - 3 insurance reps (Presidential appointment, NAIC, FIO)
 - Designates SRCs (systemically risky companies)
 - Monitors insurance and accounting issues
- Office of Financial Research (Treasury) = Collects data; develops best practices FSOC members must implement

SRCs and LBHCs (\$50b+ assets)

- Systemically risky companies and large bank holding companies:
 - Stricter regulation and oversight
 - Pay costs of the FSOC, OFR, FDIC resolutions
 - Must have a liquidation plan
 - FRB & FDIC jointly micromanage activities

Trade-off: Too-big-to-fail (TBTF) backing; but stricter regulation

Orderly Liquidation (TBTF Bailouts)

- FRB/FDIC/Treasury involved (or SEC/FIO)
- State resolution of insurers (mostly)
- Limited Federal ability to subsidize (90% fair market value)
- Assessments to recoup FDIC assistance:
 - Creditor-clawback
 - SRCs and "large financial companies"
- Trouble spots: FDIC conflict of interest and ability to create bridge insurers

Other Provisions

- Eliminates Office of Thrift Supervision (preserves thrift charter)
- Securities suitability; limits on arbitration
- Hedge/private fund registration
- Limits on proprietary trading
- Derivatives disclosure and capital
- Bureau of Consumer Financial Products
- CRA regulation (AM Best, S&P, Moodys, Fitch)
- Predatory lending restrictions

Positive Reforms

SMART Act Reforms (Nonadmitted and Reinsurance Reform Act):

- Nonadmitted (surplus lines) reform
- Reinsurance reform

Federal Insurance Office (FIO)

- Explicitly not a regulator
- No funding
- Limited treaty-making authority
- Due process and de novo review
- Data demands through regulators
- Small insurer exception

Impacts on Most Insurers = Negligible

- DFA economic drag
- FIO:
 - positive international (potentially)
 - negative market conduct
- Contraction in regulatory use of credit rating agencies
- Derivatives restrictions on end users
- Federal resolution of SR insurance holding companies
- Assessments and info demands on SR and large insurers (\$50b+)

Additional Impacts on Depository Institution-Affiliated Insurers

- Cost/benefit analysis being done on DI-affiliations:
 - Thrift charters retained but OTS abolished
 - Temporary moratorium on ILCs/Trusts/CCBs
 - Pay-Go tax (increased reserve-ratio for \$10b+ DIs)
 - Large conglomerates pay extra assessments
 - Stricter FRB oversight, especially for large conglomerates
 - Elimination of "fed-lite"
 - Increased capital requirements for DIs
 - Source-of-strength exposure
 - Reach down exposure
 - Marginal Volcker Rule exposure (proprietary trading)
 - Restrictions on affiliate transactions
 - Restrictions on changing DI charters

Additional Impacts on Lender Insurance

- BCFP has indirect authority over lender-used insurance products
 - FTC jurisdiction over insurance scores, CRAs and FCRA
 - Use of insurance by finance companies
 - Creditor/force-placed insurance
 - Credit insurance
 - Mortgage single premium credit insurance
 - Single premium credit insurance

Additional Impacts on Public Insurers

- Corporate Governance Requirements
 - Independent compensation committees
 - Pay-parity disclosures
 - Proxy access
 - Executive compensation claw-backs
 - Hedging disclosure
 - Smaller public companies exempt from Sarbanes-Oxley internal control requirements

Additional Impacts on Insurers in Federally Regulated HCs

- Limits on incentive-based compensation plans that encourage excessive risk
 - Applies to federally regulated financial institutions with at least \$1 billion assets
 - Federal regulators can jointly apply to state-regulated entities

Next Steps – DFA Implementation

- 200-355 rules
- 68-200 studies
- Immediate issues: staffing; conceptualization
- Data gathering
- Formal comment
 - FSOC comment requests on systemic risk, Volcker Rule

Our Regulatory Future

- Pressure to conform to international standards
- Pressure to match federal DFA powers
- Greater capital and risk management required
- Increased costs and regulatory fees
- Transitional uncertainty
- Deterioration of legal separateness of affiliates

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Shaping the Future of American Insurance

Future Federal Activity

- Next term: GSE reform
- 2013 FIO report
- Starting point: Treasury Blueprint
- Bad precedents in DFA / health insurance
- Congress is deeply divided
- Regulation may become more bifurcated
- Big bills usually result only from big failures

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Thank You

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**RAA PERSPECTIVE ON
KEY REINSURANCE PROVISIONS
OF THE DODD-FRANK ACT**

**CASUALTY ACTUARIAL SOCIETY
NOVEMBER 10, 2010**

MARY Z. SEIDEL, VICE PRESIDENT & DIRECTOR,
FEDERAL AFFAIRS

REINSURANCE ASSOCIATION OF AMERICA

REINSURERS WALK A FINE LINE

- Massive financial services regulatory reform bill written in an anti-Wall Street/financial services environment.
- AIG is now the “face of the insurance industry” on Capitol Hill.
- Talks of further regulatory burdens and government control.
- Does RAA duck its head or look for opportunities of insurance regulatory reform?

REINSURERS MAKE CASE FOR REGULATORY REFORM

- Reinsurers are global companies.
- Reinsurers do not have a federal voice on the international stage.
- Reinsurers losing competitive advantage abroad.
- Foreign reinsurers frustrated with 50-state system.
- Global reinsurers played critical role in the aftermath of September 11, Katrina – yet there is no expertise about reinsurance at the federal level.
- Reinsurers have no consumer elements, nor politically-charged rate and form regulation.

FEDERAL INSURANCE OFFICE INTRODUCED

- Administration and original House bill very strong on powers of the Office
- Original intent of the Office:
 - Gain federal expertise on insurance markets and policy affecting insurers
 - Provide for US insurance industry representation on international stage with powers to enter into international agreements and preempt inconsistent state law
- Constituencies, politics and insurance industry wrangled over the strength of the Office, particularly the international provisions.
- So where did we end up? It depends on who you ask.

FEDERAL INSURANCE OFFICE GENERAL PROVISIONS

- In Treasury Department, headed by Director appointed by Treasury Secretary.
- Charged with monitoring the insurance industry and coordinating federal policy positions.
- Coordinate/develop federal policy on international matters.
- Limited authority to enter into international agreements and preempt state law.
- Non-voting member of FSOC.
- Power to recommend insurers as systemically important.
- Run TRIA Program.
- Conduct studies on insurance industry.

FEDERAL INSURANCE OFFICE INTERNATIONAL POWERS

What can the Treasury Secretary negotiate an agreement?

- Secretary w/USTR negotiates "covered agreement."
 - Written bi/multilateral recognition agreement that recognizes prudential measure for business of (re)insurance that achieves level of protection for (re)insurance consumers that is substantially equivalent to level of protection achieved under State regulation.
 - Outcomes determinative test.
- Must consult with four Congressional Committees before, during and after negotiations.

FEDERAL INSURANCE OFFICE INTERNATIONAL POWERS (CONT'D)

What impact does the agreement have on inconsistent state law?

- Director can preempt State measures subject to covered agreement.
 - Savings Clause: Preemption cannot affect State capital or solvency requirement except where State measure equals less favorable treatment of non-US insurer.
- Onerous process.
 - Before determination of inconsistency: notify and consult with State and USTR and comment period.
 - After determination: notify State and four Congressional Committees.
 - Determination subject to APA and *de novo* judicial review.

FEDERAL INSURANCE OFFICE NEXT STEPS

- FIO Director to be appointed (career staff acting as transition).
- Industry will engage Director to push their interpretation of the statute.
- Will Director push the envelope on strength of Office or limit its powers?
- Enter into first international agreement and preempt state law.
- States likely to challenge preemption.
- FIO Studies (1) Role of global reinsurance market in the U.S.; (2) Impact of Reinsurance Section of NRAA; and (3) How to modernize/improve insurance regulation.
- NAIC to implement state-based reforms.
- Congressional Hearings.

STATE-BASED REFORMS REINSURANCE INDUSTRY

Dodd-Frank Wall Street Reform and Consumer Protection

NONADMITTED AND REINSURANCE REFORM ACT

- Single regulator by home State for financial solvency purposes for reinsurers.
- Credit for reinsurance decided by cedent's domiciliary regulator.
 - No other state can deny this credit for reinsurance.
- Host State's Preemption of Extraterritorial Regulation
 - Interfering with contractually agreed to arbitration;
 - Requiring specific reinsurance contract terms;
 - Enforcing agreements on terms different than reflected in agreement; and
 - Otherwise applying laws to reinsurance of agreements not domiciled in that State.





**Key Issues In Insurance Regulation
Arising Out of Dodd-Frank and
International Developments**

**Casualty Actuarial Society
November 2010**

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**Dodd-Frank Act
Major Issues**



- Systemic Risk Regulation
- Resolution Authority
- Consumer Protection
- Federal Insurance Office & Other Insurance Reforms
- Derivatives & Proprietary Trading Restrictions

**Financial Stability
Oversight Council**



- **Established under Sec. 111**
- **Treasury Secretary serves as chair**
- **10 voting members:** Treasury Secretary; Fed Chair; Comptroller of the Currency; CFPB Director; SEC Chair; FDIC Chair; CFTC Chair; FHFA Director; NCUA Chair; Independent Insurance Expert
- **5 nonvoting advisory members:** OFR Director; FIO Director; State Insurance Commissioner; State Securities Supervisor; State Banking Supervisor
- **Council duties**
 - Regulatory coordination
 - Information sharing and systemic risk monitoring
 - Designating nonbank financial companies for heightened supervision

Systemic Risk Regulation



Overview (§ 113 - Nonbank Financial Cos.):

- No insurer exemption, but key determining factors based on level of external impact on financial stability
- Separate process for U.S. and foreign cos., but similar analysis
- § 170 – regulatory safe harbor

Status:

- First area of regulatory focus
- Implementing regs should focus on those factors that present external threat to financial stability
- Other factors related to internal “safety and soundness”
- Where do property-casualty insurers fit?

Resolution Authority - Overview




- Company can be subject to FDIC resolution where it meets the FC definition and Treasury determines that the company is in danger of default and normal channel of resolution would have serious adverse effect on U.S. financial stability
- Requires judicial approval of FDIC as receiver
- FDIC resolution of an insurer must be based on recommendation and decision by the Fed (2/3 Board majority) and the FIO Director
- Possibility of insurer resolution through FDIC narrow b/c insurance subs are not defined FCs and resolution process for insurers required to be conducted under state law
- Taxpayer \$\$ recouped through post-event assessment on direct financial beneficiaries of defaulting FC.
- Systemically important FCs and large (\$50B+) FCs assessed via risk-weighted matrix only if direct beneficiary repayment is insufficient.

Resolution Authority - Status



- Resolution authority process and assessment provisions unlikely to be the first set of regulations issued unless the Administration views other large, interconnected FCs as fragile
- FDIC required to issue rule applying the revenue test to determine whether a company meets the FC definition, but no deadline for issuance
- FDIC also required to promulgate assessment rule that allows for differing assessments for different types of FCs based on risk-related factors
- Rules in this area should reinforce primacy of state-based resolution authority and low risk nature of p-c industry
- In assessments, like the § 113 systemic risk regulation determination, likelihood and size of assessment should reflect the external risk associated with the FC or sector
- Assessment rules should also provide equivalent credit for state guaranty fund obligations

Consumer Protection




Overview:

- Major Democratic “centerpiece” of legislation
- Independent consumer protection regulator housed at Bureau within Fed
- Authority extends to “consumer financial products and services”, including authority transferred under other fed laws
- “Business of insurance” excluded from Bureau jurisdiction
- Persons regulated by state insurance dept. also exempt while engaged in the “business of insurance”
- Residual Bureau authority over some practices under transferred federal laws (FCRA)

Status:


- 7/21/2011 deadline for transfer of authority to Bureau
- Elizabeth Warren appointed as Bureau advisor
- Goal is to prevent “regulatory creep” into insurance

Federal Insurance Office & Other Insurance Reforms - Overview



- **Subtitle A** – establishes FIO in Treasury and requires study of insurance regulation
- **Subtitle B** – codifies surplus lines and reinsurance reforms
- **Federal Insurance Office**
 - Separate office in Treasury to provide the Administration with expertise on life and p-c insurance (except crop insurance)
 - Functions include data collection/analysis, systemic risk monitoring, administering TRIP, monitoring affordability/availability in underserved communities, recommending insurers for fed systemic risk supervision, advising on insurance policy issues, and coordinating development of federal policy on international prudential insurance issues
 - FIO prohibited from acting as insurance regulator
 - Preemption authority exists on international issues, but is very narrow
- **Insurance Regulation Study**
 - Due within 18 months of enactment
 - Examines effectiveness of insurance regulation defined by 6 principles
 - Also studies consequences of FDIC resolution authority of insurers and federal consumer protection regulation

Federal Insurance Office & Other Insurance Reforms – Overview (cont’d)



- **Surplus Lines**
 - Creates basis for uniform system of surplus lines premium tax allocation, based on policyholder’s home state
 - Encourages states to develop compact or similar uniformity mechanism
 - Establishes regulatory deference to policyholder’s home state
 - Sets forth uniform eligibility requirements for surplus lines insurers
 - Allows insurer relief from “due diligence” requirements for certain exempt policyholders meeting threshold criteria
- **Reinsurance**
 - Applies single-state solvency regulation based on domiciliary state of reinsurer
 - Applies credit for reinsurance standards based on domiciliary state of ceding insurer
 - Prohibits non-domiciliary states from applying reinsurance laws extra-territorially

Federal Insurance Office & Other Insurance Reforms – Status



- Federal Insurance Office
 - FIO Director position still vacant
 - Council insurance voting member position vacant, but requires Senate confirmation
 - MO Insurance Director Huff appointed to NAIC non-voting member seat on Council
 - Regulatory focus on: (1) defining FIO role on systemic risk designation process; (2) placing parameters on scope of data collection authority; and (3) determining international authority of FIO
- Insurance Regulation Study
 - Outcome may shape future of federal insurance regulation
 - HFSC Chairman Frank signals that OFC hearings will occur in 2011
- Surplus lines and Reinsurance
 - Now that federal standards are in place, up to NAIC and states to implement them

Derivatives Regulation & Proprietary Trading Restrictions



Overview:

- Titles VI and VII detail restrictions on proprietary trading by “banking entities” and regulation of derivatives
- § 619 – defines banking entity to include any financial institution with an affiliated bank or thrift, and establishes prop trading restrictions on such entities
- Excludes prop trading by regulated insurers (or affiliates) for the “general account” of the insurer
- § 721 – defines “swaps” and “major swap participants” broadly

Status:

- Will “general account” exclusion be sufficient for insurers that are included as “banking entities”?
- Will the SEC/CFTC, in rulemaking, blur the distinction between federally-regulated “swaps” and “insurance contracts”?
- Are insurers “major swap participants” or subject to a commercial hedging exception?

What’s Next



Dodd-Frank--Some Priority Issues:

- Definition of systemically important financial institutions: Should not include insurers engaged in core insurance business
- Resolution: Potential secondary effects on insurers should be defined and dealt with
- Information gathering and monitoring: Should be carefully scrutinized to avoid duplication, needless waste of resources and pressure on insurers to depart from risk-based assessment and underwriting
- Representation of the interests of the U.S. in trade negotiations and international agreements on prudential matters: Should assure substantial insurer input before, during and after negotiations and a focus not on more, but better (e.g. effective and efficient) regulation

What's Next (continued)



- Relationship between FIO and State regulators: Should avoid overlap and waste of governmental and insurers' resources pending further reforms

Global Developments:

- Implementation of Solvency II, Equivalence Determination: Should be used to advance more effective and efficient regulation in the US, such as more uniform confidentiality laws, less political influence in US regulation, and the designation of a single group supervisor combined with deference from solo entity supervisors
- Global regulatory structure and standards: IAIS and other standard setters relevant to insurers should reflect insurance business model and not bleed over from banking regulation. Should result in a clear, accountable and non-duplicative global regulatory system with mandates based on rigorous cost/benefit analyses
- NAIC Solvency Modernization Initiative and other domestic responses to global standards: Should be required to result in more effective and efficient domestic regulation and prevent regulatory piling on

What's Next (Global Developments continued)



- Trade and liberalization: Should be advanced so as to promote the growth of private insurance markets. Social value of insurance includes compensation, capital for infrastructure development, increased confidence for business and families, loss control advice, and public policy advocacy for loss prevention measures
- Global regulatory transparency standard: Basic notions of notice and comment rulemaking and cost/benefit analysis should be standardized. The OECD's Policy Framework for Effective and Efficient Financial Regulation can be the foundational document
- Assisting U.S. companies to compete globally: US insurance regulation needs to focus more on efficiency, or run the risk of causing the loss of potential jobs and financial benefits for the US. (Helping EU companies be more globally competitive was, and continues to be, a major goal of the EU's Solvency II)

Conclusions



- All insurance regulation should reflect the insurance business model, be based on objectively identified problems, assure the most cost/beneficial regulatory approach and reflect a domestic and global regulatory system that prevents wasteful duplicative or contradictory mandates even as it promotes the growth of private insurance markets.
- Dodd-Frank raises many implementation issues.
- US insurance regulation is increasingly influenced by global developments such as Solvency II and IAIS standards.
- The challenge for insurers is to achieve a domestic and international regulatory system that is both effective and efficient.
- Increased Insurance trade and liberalization need to be advanced, along with a global standard on regulatory process.



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