CAS RPM Seminar
R-2 Federal vs. State Insurance Regulation

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Dodd-Frank Wall Street Reform and Consumer Protection Act

- Member, American Academy of Actuaries Financial Regulatory Reform Task Force
- Slides partially taken from the American Academy of Actuaries webinar of October 5, 2010
- The opinions presented are strictly those of the authors and not of Towers Watson or the American Academy of Actuaries

Dodd-Frank

- Creates a Systemic Risk Regulation Framework
- Among other things it crates three very important bodies
  - FSOC: Financial Stability Oversight Council
  - OFR: Office of Financial Research
  - FIO: Federal Insurance Office

FSOC Responsibilities

- Authority over bank holding companies with assets over $50 billion **and nonbank financial companies which the FSOC deems a systemic risk to financial stability.**
- Designate specific companies (**including insurance companies**) as “systemically important”
- Instruct Federal Reserve to impose measures to regulate these companies
- Permit the Federal Reserve in extreme cases to order companies to divest assets (or to be broken up)
- Collect information from other regulators (federal and state)
- **Identify regulatory gaps**
- **Identify other threats to US financial stability**
- Facilitate cooperation and resolve disputes among regulators
- Monitor US financial markets: integrity, efficiency and competitiveness

FSOC

- “… arguably, the most powerful regulatory body in the world” (WSJ)
- Not a supervisor
- Not an executive body
- An identifier of targets
- An instructor to regulators

OFR Responsibilities

Where the work is done! It is the central administrative body supporting the FSOC

- Provide full administrative support for the FSOC
- Provide expertise on systemic risk
- Draft reports to, and for issuance by, the FSOC
- Make recommendations to the FSOC on target companies, regulatory measures, risks and the overall markets
- **Data Center** will collect data from:
  - Member agencies
  - Other agencies, e.g., state agencies
  - Commercial entities
  - Financial entities including the actuarial bodies

OFR Responsibilities

- **Research and Analysis Center** will:
  - Develop and maintain metrics
  - Monitor changes in system-wide risk levels and patterns
  - Evaluate stress tests on organization overseen by member agencies
  - Investigate problems and failures of financial markets
  - Conduct studies on efficacy of policies related to systemic risks
  - Promote best practices for financial risk management

FIO Responsibilities

- The FIO is the **first** federal insurance body
- Charged with:
  - National coordination of the insurance sector
  - **Identification of system threatening gaps in insurance regulation**
  - **Identification to the FSOC of any insurer that is systemically relevant**
  - Responsibility for US in International insurance regulatory interaction
- Includes Life, P&C. Excludes only health insurance and some minor lines

FIO Reporting

- Annual Report on the state of the US insurance industry and FIO actions
- Special report within 18 months of enactment on modernization of US insurance regulation
  - **Systemic risk regulation with respect to insurance companies**
  - Relationship between capital and liability standards
  - Standards of liquidity and duration risk
  - Consumer protection, including state regulatory gaps
  - Uniformity in regulations among states
  - Regulation of insurance groups on a consolidated basis
  - International coordination of insurance regulation
  - **Cost and benefits of federal regulation across lines of insurance**
  - Feasibility of only regulating certain lines at federal level
  - Ability of federal regulation to eliminate or minimize regulatory arbitrage
  - Impact of international regulatory developments on potential federal regulation
  - Breadth and scope of global reinsurance market and its role in supporting (or otherwise) the US insurance industry

Property & Casualty Insurance Industry

There is general relief that the Act does not target P/C insurers as posing significant systemic risk

- Leigh Ann Pusey, president of the American Insurance Association, released the following statement on 9/16/2010:

  "The American Insurance Association supports efforts to reform and modernize financial services regulation. The bill passed today largely recognizes that property and casualty insurers do not pose systemic risk."
- P&C insurers with greater than $50 billion in assets who do not meet the definition of banks appear not to be subject to being declared systemic risks
  - The $50 billion automatic supervision only applies to "Large Bank Holding Companies"
  - There is a 9 factor test for "US and Foreign Non Bank Financial Companies" to be subject to regulation and oversight by the Federal Reserve Board (A "Designated Company")
  - They have to be "predominantly engaged in financial services" as defined in the Bank Holding Company Act of 1956

Streamlines Reinsurance Placements

- Ceding insurer's state of domicile regulates:
  - Credit for reinsurance, if NAIC accredited or similar
    - Other states can't impose rules for "admitted" reinsurer credit and must accept credit granted by cedant's state of domicile
    - Non-US domiciled reinsurers may receive similar benefit
- Reinsurer's state of domicile still regulates:
  - Reinsurer solvency, if NAIC accredited
    - Other states can't require additional financial info

Non-US Reinsurers

- If no branch or company licensed in cedant's state of domicile:
  - Still have to post collateral unless a master trust is approved by cedant's state of domicile
  - Many states relax capital requirements for highly rated reinsurers domiciled in countries with appropriate regulatory environments (e.g., Germany)
- As with domestic reinsurers, if reinsurance credit is granted by cedant's state of domicile, all other states where cedant is licensed must accept the reinsurance

Streamlines Non-Admitted Placements

- Admitted carriers are primary insurance companies that are either licensed or domiciled in any given state
- Non-admitted, or Excess & Surplus Lines, carriers sell commercial insurance in states in which they are not licensed
  - Permitted by US law, with a variety of regulations
    - White and black lists
    - Premium tax issues
    - Who they may write and under what conditions

Streamlines Non-Admitted Placements

- Act designates one state, the **home state of the insured, to regulate non-admitted placements**
  - Home state defined as insured's "principal place of business," which is not defined
- Home state collects premium tax for non-admitted placements
  - States may adopt legislation or enter an agreement to allocate premium tax paid to the home state
  - The NAIC may submit a report describing any allocation agreement reached among the states
  - If no allocation agreement is reached, states, other than the home state, will not receive their portion of premium taxes
- States should participate in the NAIC's national insurance producer database for the licensure of surplus line brokers
  - After two years, non-participating states cannot collect surplus lines broker license fees

Streamlines Non-Admitted Placements

- Capital and surplus requirements for US domiciled insurers are required to conform to NAIC Non-Admitted Insurance Model Act, establishing uniform standards.
- States cannot prohibit surplus lines brokers from doing business with non-admitted insurers on the NAIC IID's Quarterly List of Alien Insurers, eliminating separate state listings for non-US insurers.
- State diligent search requirements for exempt commercial purchasers are pre-empted, provided broker advises that insurance may be available on admitted paper and purchaser requests non-admitted placement in writing.

So Why Revisit Federal vs. State Regulation?

- P&C Insurance is a global business with many large global players
- P&C marketplace is robust
- The Current Regulatory System Has Served Us Well
- System of guaranty funds provide a great deal of consumer protection
- Most problems solved over time
  - For example
    - **Fall of bond values and high inflation in the 1980's**
    - **Financially questionable reinsurance market**
    - **Periodic insurance capacity issues for personal auto, medical malpractice, etc.**
    - **Failure of major insurers**
    - **Protection of consumers**
- It is possible, perhaps likely, that a system of Federal regulation could have done a similarly good job
- However, is it likely that it would have done, or could do a better job?

So Why Revisit Federal vs. State Regulation?

- Dodd-Frank will not generally supersede or duplicate state regulation and does not impose onerous new federal or dual state/federal regulation on the P&C insurance industry
- However, there is apprehension that it could ultimately change or form another layer of regulation.
- Dodd-Frank opens the door to federal regulation a crack
- The definition of swaps is extremely broad and doesn't explicitly exclude insurance contracts
  - While swaps are not regulated as insurance, it is conceivable that some insurance contracts could be considered as swaps
  - FSOC has the power to name potentially systemic insurance companies
  - Creation of the FIO
  - Responsibility for US in International insurance regulatory interaction
- Unknown what FIO report, due in 18 months, will say about regulation