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INSURANCE PRACTICE GROUP

DODD-FRANK TASK FORCE

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"What keeps you up at night?"

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The Ghost of Christmas Future – The Dodd-Frank Act and its impact on the regulation of the insurance and reinsurance industries

By Michael F. Consedine

SUMMARY

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act will unquestionably lead to major reverberations in the regulation of traditional financial institutions such as banks, private equity firms, hedge funds and others. The Act has, however, very little immediate impact on insurance companies. The primacy of state regulation remains in place and there is no optional federal charter – both of which were still in question just a few months ago. The Act has more of a direct impact in surplus lines insurers and reinsurers, although it does not overhaul the existing credit for reinsurance scheme as had been previously proposed by the National Association of Insurance Commissioners ("NAIC") and others. It does, however, set the stage for potential larger changes and broader federal regulation of the insurance industry.

> *Before I draw nearer to that stone to which you point," said Scrooge, "answer me one question. Are these the shadows of the things that Will be, or are they shadows of things that May be, only?"*
>
> *Still the Ghost pointed downward to the grave by which it stood.*
>
> *"Men's courses will foreshadow certain ends, to which, if persevered in, they must lead," said Scrooge. "But if the courses be departed from, the ends will change. Say it is thus with what you show me!"*
>
> Charles Dickens – *A Christmas Carol*

In Dickens' *A Christmas Carol,* the Ghost of Christmas Future transports Scrooge to his desolate grave and paints a fairly depressing future for Scrooge, Bob Cratchit, Tiny Tim and others. Six months ago, state insurance regulators and those in the industry favoring the current system of state regulation of insurance had a visit from their own Ghost of Christmas Future. A similarly bleak future was painted for this group – a future where states were not the exclusive regulator of insurance, where some insurers could choose to be licensed and regulated by a federal insur-

ance regulator, and where the regulation of reinsurance was radically overhauled at a federal level. Consequently, the passage of the final version of the Dodd-Frank Wall Street Reform and Consumer Protection Act, that contained none of these dramatic proposed reforms, must have seemed as a deliverance from that portended grave of state regulation. That reprieve, however, may be only illusory and temporary. For the Act itself serves as another Ghost of Christmas Future and some of its provisions hint at the "shadow of things that may be." This alert briefly highlights what the Act left unchanged, what it has added, and what it portends may be in store for the insurance and reinsurance industries.

WHAT IS THE SAME?

- **Primacy of State Regulation Left Untouched/ No Federal Regulator.** The Act has very little impact on the current regulation of insurance companies. Crucially, the Act left the existing system of state regulation largely intact. This is a mixed blessing of sorts for insurers. On the one hand, they generally will not be required to institute a myriad of new Act-imposed compliance processes and procedures as will their brethren in the banking and securities industries.On the other hand, however, insurance companies are left with a regulatory status quo and with a system that its critics attack as too provincial and inefficient when compared to the unified regulatory systems in place in Europe and elsewhere. As discussed below, while the Act creates a new Federal Insurance Office, this entity does not serve the functional equivalent of a state insurance regulator. In short, the Act leaves the McCarran-Ferguson Act intact and does not usurp state insurance departments as the primary regulators of insurance.
- **No Optional Federal Charter.** Much to the dismay of the ACLI and other advocates of the creation of an optional federal charter/license for insurance companies, the Act does not provide for an alternative federal licensure structure for certain classes of insurers. Consequently, insurance companies have no option other than to continue to operate in the current state licensure environment.
- **No Major Changes to Existing State Reinsurance Collateralization Requirements.** The Act does not alter the current scheme of collateral requirements for admitted and non-admitted reinsurance companies. Accordingly, in most states (some states have modernized their regulations), admitted U.S. reinsurers will continue to have a competitive advantage over their foreign non-admitted competitors who will generally have to continue to meet any collateral requirements imposed by the ceding insurer's state of domicile.
- **No National Producer Licensing System.** For several years, Congress has been toying with imposing a national licensure option for insurance producers – the National Association of Registered Agents and Brokers Reform Act or "NARAB." The Act does not include any form of NARAB. Consequently, producers will continue to be governed by state licensure requirements.

WHAT'S CHANGED?

- **Creation of Federal Insurance Office ("FIO").** While its powers are relatively limited, the FIO represents the first federal agency solely dedicated to non-health insurance lines of business. The FIO's oversight functions cover all lines of insurance except for health, long-term care, and crop insurance – which are all already subject to some form of federal regulation. The FIO will be an office within the Department of Treasury headed by a Director appointed by the Secretary of Treasury. The Act tasks the FIO with certain specific responsibilities that all generally fall into the categories of "monitor," "study" and "report."
    - Chief among the FIO's review and reporting responsibilities is monitoring the insurance industry and gathering information, including "identifying issues or gaps in the regulation of insurers that could contribute to systematic crisis in the insurance industry or the United States financial system" and to annually report its findings to Congress. The Act gives the FIO certain powers to

gather information, including limited subpoena power. The Act also requires the FIO to issue reports within the next 18 months on the modernization of the insurance regulatory system in the U.S. and a report on the U.S. and global reinsurance markets.

- The FIO's most substantial authority comes in the arena of international agreements. Under the Act, the Treasury and U.S. Trade Representatives are authorized to enter into agreements with foreign governments with respect to recognition of prudential measures relating to the business of insurance and reinsurance. In implementing any agreements, the FIO is given limited authority to preempt any state insurance laws that are inconsistent with the international agreements or treat any non-U.S. insurer less favorably than a U.S. insurer.

- **Clarification of Surplus Lines Regulation.** The Act includes a separate subtitle, the Nonadmitted and Reinsurance Reform Act ("NRRA") that has a more direct impact on surplus lines insurance but only to the extent that it clarifies which state has primary jurisdiction over a surplus lines placement. The NRRA will go into effect in approximately 11 months. The NRRA provides that the state of the insured serves as the "home state" and has exclusive jurisdiction to regulate the placement of nonadmitted insurance, including broker licensure requirements. The NRRA defines a "home state" as the state where the insured maintains its principal place of business, except that if 100 percent of the insured risk is located in other states, the "home state" shall be the state to which the greatest percentage of the insured's taxable premium is allocated. Importantly, only the home state will have the right to collect premium taxes for nonadmitted insurance, even where the insured has significant operations in another states. The NRRA provides that states "may" enter into compact or other agreements for the allocation of premium taxes among them. Additionally, states are prohibited from establishing eligibility criteria for surplus lines insurers other than those currently in the NAIC's Nonadmitted Insurance Model Act. Moreover, states may not prohibit surplus lines brokers from doing business with nonadmitted insurers listed on the NAIC international insurer department quarterly listing of Alien Insurers. The NRRA will also preempt any state diligent search requirements for certain sophisticated commercial purchasers and where the broker has made certain availability disclosures.

- **Clarification of Reinsurance Regulation.** The NRRA also provides some clarity over the standards for state regulation of reinsurance and adopts some of the Reinsurance Regulatory Modernization Framework Proposal adopted by the NAIC in 2008. As previously noted, however, it does not significantly reform existing collateral requirements, which has been the source of much of the current debate at the NAIC. The NRRA confirms that the ceding insurer's state of domicile serves as the sole regulator for purposes of credit for reinsurance requirements, provided that the state is NAIC-accredited or otherwise has financial solvency requirements substantially similar to the NAIC's requirements. The NRRA further provides that the ceding company's laws will also govern: (1) the rights of the parties to agree to resolve disputes through contractually agreed upon arbitration, (2) choice of law, (3) imposition of standard terms other than those in the contract. The NRRA preempts the extraterritorial application of laws of other states in these areas to the extent they conflict with the home state. Finally, the ceding insurer's state of domicile is solely responsible for regulating the reinsurer's solvency provided the state is NAIC-accredited.

WHAT MAY BE IN STORE?

- **Stage Set for Potentially More Comprehensive Federal Regulation.** At the very least, the Act plants the seed for further federal regulation of insurance. Whether that seed germinates and grows depends on a variety of political, economic, and regulatory considerations. Certainly, the FIO's studies and reports on

the state of the insurance industry and regulatory modernization will be telling. Additionally, a dramatic insolvency of a large national U.S. insurance company would also provide further fuel for proponents of federal regulation. The NAIC, however, is clearly aware of the fact that it now has the federal government, and the FIO specifically, peering over its shoulder and it will be interesting to see if the pace of the NAIC's uniformity and "speed to market" reform initiatives increase and are adopted by more states. Regardless, proponents of federal regulation are expected to stay on the attack and use the Act as a potential launch pad for far more comprehensive federal regulation.

- **Resolution of Reinsurance Collateral Requirements.** The Act provides a mechanism for the federal government to establish national credit for reinsurance requirements and to preempt any conflicting state laws. Again, whether this happens is subject to several variables. First, the U.S. will need to reach an agreement with its foreign counterparts, including credit for reinsurance standards that are substantially different from the current state models. U.S. domiciled reinsurers can be expected to lobby against any standards that open the door for increased competition from their foreign competitors. Second, the FIO will need to exercise its limited preemption power over any conflicting state requirements. Third, the FIO's preemption will need to survive the more than likely judicial challenge that will follow such an action and the Act requires that any judicial review be *de novo* – meaning courts will not apply any deference to the FIO's determinations.
- **Surplus Lines Tax Battle.** Given the current dire financial condition of many states, the NRRA sets the stage for a battle for nonadmitted premium tax dollars between states with a substantial population of "home state" insureds (and who are therefore entitled to all of the resulting taxes) and those states with few home state-insureds but substantial insured operation or manufacturing presences.

CONCLUSION

There is little question that the Act serves as the Ghost of Christmas Future to state insurance regulators and the insurance industry and certainly paints shadows of "what may be." How that future resolves itself will depend on the course and actions of regulators, the federal government, the industry, the economy and others players. We will continue to monitor the implementation of the Act, in particular, regulations and FIO reports that will be issued in the coming months, and report any material developments.

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