2010 Insurance Economic Summit: Navigating the Era of Reform

FOLEY
FOLEY & LARDNER LLP

LECG

MACQUARIE

Federal Financial Services Reform

Kevin G. Fitzgerald, Partner, Foley & Lardner, LLP
Robert C. Leventhal, Partner, Foley & Lardner, LLP

Federal Financial Services Reform

- A look at provisions impacting the insurance industry that survived the “final round” of financial services reform
- What was left on the cutting room floor
- What is still to come – a look into the future

Nonadmitted and Reinsurance Reform Act of 2010:

General Comments

- Scope: Minor part of the Dodd-Frank Act (less than 1% of page count)
  - NRRA (8 Pages)
  - Dodd-Frank Act (848 Pages)
- Effective Date: July 21, 2011 or later
- Legislative History: A version of the NRRA has been introduced in Congress in 2006, 2007, 2008 and 2009
- Applicability: Nonadmitted insurance provisions do not apply to risk retention groups

Nonadmitted and Reinsurance Reform Act of 2010:

Premium Taxes

- *No other state* than the home state of insured may require premium tax payment
- The term “home state” means for
  - *Business entities*: the principal place of business
  - *Natural persons*: the principal residence
  - *Affiliates under single policy*: the home state of the member of the affiliated group that has the largest percentage of premium attributed to it
  - **But,** if 100 % of the insured risk is outside of the state of the principal place of business or residence, the state to which the greatest percentage of the insured’s taxable premium for the policy is allocated becomes the home state.

Nonadmitted and Reinsurance Reform Act of 2010:

Premium Taxes

Example

A policy is placed by a surplus lines broker with premiums of $ 900,000 for risks of equal amounts in Florida, Iowa and Puerto Rico.

Currently, the broker must allocate premium and collect and remit taxes on the multi-state risks to the different states at the states’ applicable tax rates (FL = 5%, IA = 1%, PR = 9%). The total tax payable to FL, IA, and PR would be **$45,000**.

Under NRRA, however, the broker would only remit taxes to the home state at the home state’s rate. (The home state could then allocate part of the taxes to other states if an interstate compact was adopted.) If the home state of the insured was

Florida, the tax would be	$ 45,000;
Iowa, the tax would be	$ 9,000;
Puerto Rico, the tax would be	$ 81,000.

Despite no change in risk or premium amount, the surplus tax payable under NRRA can have great variability solely based on the home state of the insured.

Nonadmitted and Reinsurance Reform Act of 2010:

Interstate Compact

- The allocation of taxes on multistate risks may be established by interstate compact
  - NAPSLO, ELANY and other organizations have drafted the Surplus Lines Insurance Multi-State Compliance Company (SLIMPACT), which, if adopted, would create a clearinghouse and electronic reporting system for storing and reporting tax allocation data.
  - The International Fuel Tax Agreement (IFTA) also has been considered as a model to use.
- Congress intended there to be a uniform system for payment and allocation
- The home state may require surplus line brokers to file tax allocation reports detailing portions of nonadmitted policy premiums attributable to risks located in each state

Nonadmitted and Reinsurance Reform Act of 2010:

Placement Regulation

- *Only* the insured's home state may
  - set requirements for the placement of nonadmitted insurance
  - license a surplus lines broker to sell, solicit, or negotiate nonadmitted insurance
- State laws applying to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home state is another state are preempted
  - *except for* state laws restricting placement of workers' compensation insurance or excess insurance for self-funded worker's compensation plans

Nonadmitted and Reinsurance Reform Act of 2010:

National Producer Database

- States must participate in the NAIC national insurance producer database (or an equivalent uniform national database).
- After July 21, 2012, non-participating states are prohibited from collecting fees for surplus lines broker licensing.

Nonadmitted and Reinsurance Reform Act of 2010:

Uniform Standards for Surplus Lines Eligibility

- If a nonadmitted insurer is listed on the NAIC's Quarterly Listing of Alien Insurers, a state cannot prohibit surplus lines brokers from placing through that non-admitted insurer.
- A state may not impose eligibility requirements on a U.S. nonadmitted insurer, except in conformity with the requirements of NAIC Non-Admitted Insurance Model Act Sections 5A(2) and 5C(2)(a), unless the state has adopted nationwide uniform requirements that include alternative nationwide uniform eligibility requirements.

Nonadmitted and Reinsurance Reform Act of 2010:

Commercial Purchaser

- A surplus lines broker procuring nonadmitted insurance for an "exempt commercial purchaser" is not required to satisfy state diligent effort requirements if
  - the broker has disclosed to the purchaser that the coverage may or may not be available from the admitted market and
  - the purchaser requests in writing that the broker place the insurance with a nonadmitted insurer

Nonadmitted and Reinsurance Reform Act of 2010:

Commercial Purchaser

- An "exempt commercial purchaser" means a purchaser of commercial insurance that, at the time of placement,
- employs or retains a qualified risk manager
- paid nationwide commercial premiums of $100,000 over the past 12 months <u>and</u>
- One of the following

(i) has $20,000,000 in net worth,
(ii) has $50,000,000 in annual revenues
(iii) employs 500 FTEs or is in a group employing 1000 FTEs
(iv) if a non-profit, has budget expenditures of at least $30,000,000
(v) if a municipality, has a population in excess of 50,000 persons

Nonadmitted and Reinsurance Reform Act of 2010:

Credit for Reinsurance

- No credit for reinsurance may be denied by a state if the cedent's state of domicile
  - is an NAIC-accredited state or has substantially similar solvency requirements <u>and</u>
  - Recognizes credit for reinsurance for the cedent's risk
- All laws, regulations and other actions of a state that is not a domiciliary state of the cedent are preempted to the extent that they
  - Restrict rights of ceding insurer or assuming insurer to resolve disputes pursuant to contractual arbitration.
  - Require a certain state's law governs a reinsurance dispute or a reinsurance contract.
  - Attempt to enforce a reinsurance contract on terms different than those set forth in the contract.
  - Otherwise apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in the state.

Except that any law with respect to taxes and assessments on insurers and insurers' income are not preempted

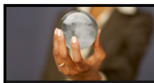
Nonadmitted and Reinsurance Reform Act of 2010:

Reinsurer Solvency

- If a state is an NAIC-accredited state or has substantially similar solvency requirements, that state has ***sole*** responsibility for regulating solvency of reinsurers domiciled in that state.
- No other state may require the reinsurer to provide financial information other than information the reinsurer is required to file with the domiciliary state.

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Set Up Dual System of Regulation: Insurance Companies and Producers Could Choose Between State or Federal Regulation.
  - National Office of Insurance set up within the Treasury Department. Headed by National Insurance Commissioner who would be appointed by the President.
  - The Commissioner would have broad authority to issue charters to, and regulate, national insurance companies and national insurance agencies.



Federal Insurance Reform-What Was Left On The Cutting Room Floor

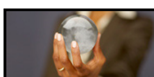
- The National Insurance Consumer Protection Act
  - Insurance companies could receive charters for property and casualty insurance and/or life insurance.
  - Federally chartered insurance companies could also maintain separate accounts in connection with insurance securitizations, provide investment advice and investment management services, and hold and accumulate funds pursuant to funding agreements.
  - A federally chartered national insurance agency could engage in the sale, solicitation and negotiation of: (1) insurance policies issued by a state or federally chartered insurer; (2)Surplus lines or nonadmitted insurance.
  - A state licensed producer could sell federally chartered insurance.

 10.7170

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Reinsurance.
    - The Act covers reinsurance of federally chartered insurers. State law governs other reinsurance.
    - The Commissioner has exclusive authority over reinsurance pools covering both nationally and state chartered insurers.
  - Certain corporate transactions by federally chartered insurers require the Commissioner's approval (including setting up subsidiaries).

 10.7170



Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - The Commissioner is required to promulgate standards (applicable to national insurers and agencies) on:
    - Accounting and Disclosure
    - Auditing
    - Risk Management
    - Internal Controls
    - Investment
    - Capital and Liquidity
    - Actuarial Opinions
    - Reinsurance
    - Other Maters that the Commissioner Deems Necessary

    The Commissioner is required to take NAIC Standards into Account.

 10.7170

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Policy forms must be filed with the Commissioner.
  - The Commissioner may not require an insurer to use a specific rate, rating element, or price.
  - The Commissioner would be required to implement the Unfair Trade Practices Act and the Unfair Claims Practices Act of the NAIC.
  - Commissioner could impose reporting requirements and would conduct examinations at least every 24 months.
  - Commissioner would have enforcement powers.
  - Commissioner could delegate certain of his powers to Self Regulatory Organizations

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Consumer Protection Provisions.
    - Division of Consumer Affairs
      - Offices in every state
      - Each insurer and agency would appoint a consumer liaison and establish procedures to resolve complaints

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Division of Insurance Fraud
    - Responsible for investigating suspected fraudulent acts by national insurers, national insurance agencies and other persons.
    - Restitution
    - Criminal offense - fine and imprisonment

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Division of Insurance Fraud
    - Fraudulent Insurance Act:
      - False information presented to insurer or producer regarding: an application, a claim, premium, financial condition of an insurer, an insurance company's corporate transactions, the issuance or reinstatement of insurance.
      - Solicitation or acceptance of new or renewal business on behalf of an insurer the person knows to be insolvent;
      - Removal, destruction or alteration of records
      - Transacting business in violation of licensing laws
      - Conspiracy

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- The National Insurance Consumer Protection Act
  - Preemption of the application of many state laws to national insurers and agencies.
  - Funded through annual assessments on national insurers.
  - Commissioner can appoint a conservator or receiver for insolvent companies
  - Nation Insurance Guarantee Corporation
  - Federal antitrust laws applicable to insurers except with respect to the development and use of policy forms or to the extent that the national insurers are subject tot state law.

Federal Insurance Reform-What Was Left On The Cutting Room Floor

- Opposition to Federal Insurance Reform
  - The National Insurance Consumer Protection Act is just one of a number proposed acts that failed over the past 4 years.
  - Treasury Secretary Paulson published a Blueprint for a Modernized Financial Regulatory Structure that recommended a federal regulatory structure for insurance including an optional federal charter.
  - Such a system would benefit the industry by making it easier to compete on a national basis and would benefit consumers with more competition and lower regulatory costs.

Federal Insurance Reform-What Was Left On The Cutting Room Floor

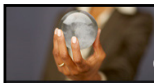
- Opposition to Federal Insurance Reform
  - Reform has been vigorously opposed by the NAIC and the states.
  - Opponents of the reform have characterized it as weakening consumer protection.
  - They have also claimed that two parallel systems of regulation would lead to regulatory arbitrage.
  - Federal regulation would create a new federal bureaucracy and result in out-sourcing of regulatory functions to self regulation

Federal Insurance Reform-What s To Come - A Look Into The Future

- Industry Reaction. KPMG Survey Results showed that:
  - 53% supported the establishment of the Federal Insurance Office, provided it is not redundant with state regulation
  - 25% opposed it because the state regulated system works well
  - 22% of respondents were unsure

Federal Insurance Reform-What s To Come - A Look Into The Future

- Implementation of the Act
  - The Office of National Insurance is still in the preliminary stages of establishment
  - Applications for Director were due by October 20, 2010.
  - On October 6, 2010, the Financial Stability Oversight Council published an Advanced Notice of Proposed Rulemaking, seeking public comment regarding the regulation of certain nonbank financial companies. The comments must be submitted online by November 5.
  - John Huff was appointed by the NAIC as its non-voting representative on the Council.
  - A voting insurance expert representative will be appointed by the President. The Director of the FOI will be a nonvoting member.
  - On October 19, 2010 the FDIC promulgated its notice of proposed rulemaking adopting rules implementing the orderly liquidation provisions of the Dodd-Frank Act.

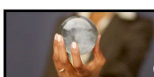


Federal Insurance Reform-What s To Come - A Look Into The Future

- The Financial Reform Act requires a report to Congress not later than 18 after its enactment on how to modernize and improve the system of insurance in the united states. This report must address:
  - Systemic risk regulation
  - Capital standards
  - Consumer protection and gaps in state regulation
  - The degree of national uniformity of state insurance regulation
  - The regulation of insurance companies and affiliates on a consolidated basis
  - International coordination of insurance regulation

Federal Insurance Reform-What s To Come - A Look Into The Future

- The report shall also examine the following factors:
  - The costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance)
  - The feasibility of regulating only certain lines at the federal level
  - The ability to eliminate of minimize regulatory arbitrage
  - The impact of developments in foreign regulation of insurance on the potential for federal regulation of insurance.
  - The ability of any potential Federal regulation or regulator to provide robust consumer protection for policyholders



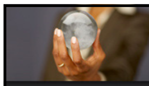
Federal Insurance Reform-What s To Come - A Look Into The Future

  - The potential consequences of subjecting insurance companies to a Federal resolution authority, including the effects of any Federal resolution authority-
    - On the operation of state guaranty fund systems, including loss of guaranty fund coverage if an insurance company is subject to Federal resolution authority
    - On policyholder protections including the loss of protection over other unsecured claims
    - In the case of life insurance, the loss of the special status of separate account assets and liabilities
    - The international competitiveness of insurance companies.

Federal Insurance Reform-What s To Come - A Look Into The Future

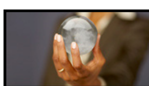
- The Report must contain any legislative, administrative, or regulatory recommendations the Director determines appropriate to carry out the findings set forth in the report.

- In conducting the study and drafting the report, the Director is required to consult with the NAIC, consumer organizations, representatives of the insurance industry, policyholders, and other organizations and experts as appropriate.



Federal Insurance Reform-What s To Come - A Look Into The Future

- The FOI will have authority to recommend to the Financial Stability Oversight Counsel that an insurer be designated as an entity that should be regulated as a nonbank financial company.
  - Prior to designating a company as a nonbank financial company, the FSOC must provide the company with notice that it intends to designate it.
  - The company has 30 days to request a hearing and an additional 30 days to submit material. Upon holding a hearing, the FSOC has 60 days to issue a decision.
  - If the company does not request a hearing, the FSOC must notify the company of its final determination with 40 days after the company received the notice.



Federal Insurance Reform-What s To Come - A Look Into The Future

- Study of the Nonadmitted Market.
  - The Comptroller General shall conduct a study of the Nonadmitted market to determine the effect of the enactment of the Act on the size and market share of the nonadmitted market for providing coverage typically provided by the admitted market. The study shall determine and analyze:
    - The change in size and market share providing such business in the 18 months following enactment.
    - The extend to which insurance coverage has shifted to the nonadmitted market.
    - The consequences of any change on the price and availability of coverage in the admitted and nonadmitted markets
    - The extent to which insurance companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted.
    - The extent to which there has been a change in the number of individuals who have nonadmitted insurance policies, the type of coverage provided under such policies, and whether such coverage is available in the admitted market.

Federal Insurance Reform-What s To Come - A Look Into The Future

- If the Director determines that a state insurance measure is preempted, the Director shall:
  - Notify and consult with the state;
  - Publish a notice in the Federal Register; and
  - Provide interested parties an opportunity to submit written comments to the Office
- The Director's determination is subject to appeal under the Administrative Procedure Act.

 10.7170

Federal Financial Services Reform

Questions?

 10.7170