Insurance Regulation in the Dodd-Frank Act: Why You Should be Concerned

For the most part, the insurance industry largely escaped the wrath of the Dodd-Frank Wall Street Reform and Consumer Protection Act — the federal financial reforms that passed on July 21, 2010, as a result of what Congress called "the worst financial crisis since the Great Depression." Although the industry successfully avoided congressional crosshairs by vilifying Wall Street and big banks as the major causes of the financial meltdown, that's not to say that the insurance industry is immune from feeling any of Dodd-Frank's impact.

There is relatively unanimous agreement that the impact to surplus lines and reinsurance sectors is positive, as the industry drove the reforms contained in the Non-Admitted and Reinsurance Reform Act, which is included in Title V of the Act. But there are mixed feelings on the impact of other changes, such as the creation of an information-gathering federal office that will gather industry stats and assess the effectiveness of a federal insurance regime.

Despite whether you view the Dodd-Frank insurance reforms as positive or negative, one consideration remains universal: The key to your company's fate lies in the ability to monitor effectively — and even influence — the administrative implementation of these measures on state and federal levels. The following provides a breakdown of the major reforms, plus insight into the areas in which the governmental relations advocacy will be essential.

I. Introducing: The Federal Insurance Office

Title V of the Dodd-Frank Act creates a new federal agency, the Federal Insurance Office (FIO). Housed within the U.S. Department of Treasury, the FIO will monitor "all aspects of the insurance industry," as well as "the extent to which traditionally underserved communities … have access to affordable insurance products." The FIO will also advise the Secretary of Treasury on "major domestic and prudential international insurance policy issues" and will consult with the states and their insurance regulators on insurance matters of national and global importance.

In short, the new office is an insurance watchdog agency that also helps to streamline international transactions, making it easier for insurance companies to negotiate international contracts without having to coordinate with 50 state regulators. Indeed, the Act recognizes that "nothing in [the Act] shall be construed to establish or provide the [FIO] or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance."

But lest ye be inclined to rest easy with the thought that the FIO's limited monitoring abilities will pose minimal risk to the industry, consider the following ways in which the FIO's newfound authority could change the status quo:

Systemic Risk Determinations: Although the insurance industry escaped many of the Act's financial reforms, there is nevertheless an unprecedented window of opportunity for the Federal Reserve Board to regulate or supervise an insurer that is deemed a "nonbank financial company." The FIO serves in an advisory capacity to the newly created Financial Stability Oversight Council — an agency charged with identifying and responding to risks that emerge in the U.S. financial system. The Act allows the FIO to identify for the Federal Stability Oversight Council any insurance company whose operations pose systemic risk to either the insurance industry or the U.S. financial system as a whole. This would subject the company to oversight and regulation by the Federal Reserve Board, which marks the first time since the 1945 passage of the McCarran-Ferguson Act that insurers would be subject to federal regulation.

Annual Reports on U.S. Insurance Climate: The FIO is tasked with issuing several reports, including:

- A reinsurance report on the breadth and scope of the global reinsurance market, analyzing the effect the Act has had on the ability of state regulators to access reinsurance information in their jurisdictions; and

- An annual report on the number of times the FIO has preempted inconsistent state insurance laws. The annual report may also report on "the state of the insurance industry and any other information as deemed relevant."

The troublesome aspect of the annual report is that Congress has given the FIO a seemingly open-ended ability to choose what information to include in its annual report. The ability to "cherry-pick" items important to the FIO's agenda is powerful, as those items will likely become the first to make it onto the congressional radar. Therefore, it is important that insurance companies monitor the drafting of the annual report, ensuring that its contents include issues favorable to their agenda and that unfavorable issues are excluded.

Insurance companies would also be wise to advocate for the person they believe should be chosen as director of the FIO, who will be appointed by the Secretary of the Treasury. Since the director will largely drive how much of an activist the FIO is to become, the industry must ensure that the director will not seek to expand jurisdiction when it comes into conflict with the state regulators.

Study and Congressional Report on Insurance Regulation: One of the more important FIO tasks is to conduct a study and, within 18 months after enactment, issue a congressional report about how to "modernize and improve" insurance regulation in the United States. Most of the guidelines are aimed toward determining the feasibility of switching to a standardized, consolidated national regulatory scheme. Factors up for consideration in the study include:

- ***Feasibility:*** Is it feasible to regulate certain lines at the federal level and leave regulation of other lines to the states?
- ***Cost:*** What is the cost vs. benefit if insurance is regulated on the federal level?
- ***Consumer Impact:*** Can federal regulation provide insureds adequate consumer protection?
- ***Foreign Impact:*** What effect will the advancement of regulation in foreign jurisdictions have on the federal regulation of insurance?

Congress also asks the FIO to identify and recommend the regulatory acts necessary to effectuate the report's findings. Thus, like the annual report, this feasibility study is a veritable battleground for proponents to avail the merits of a federal regulatory scheme. As for those who support the retention of a state regulatory scheme, monitoring the findings in this report should be at the top of the priority list.

- **Information-Gathering and Subpoena Power:** In carrying out its reporting and consulting duties, the FIO can ask insurers and their affiliates to submit an unprecedented amount of data to the federal government. The Act gives the director subpoena power over the production of the data, but the subpoena power is not unlimited. Several requirements are intended to prevent unwarranted fishing expeditions:

- ***Reasonable Relation:*** To avoid potentially burdensome or irrelevant document production, the information must reasonably relate to the performance of the FIO's functions;
- ***Industry as a Last Resort:*** To avoid duplicitous document production, the director must first consult any publicly available resources and coordinate with state insurance regulators and/or other federal agencies to ensure that information cannot first be collected from sources other than the insurer or its affiliates.

Small Insurer Exemption: The Act also provides that small insurers or their affiliates may be exempt from reporting obligations, but the FIO is entitled to establish the minimum size threshold by order or rule. Therefore, if smaller insurers predict that this reporting requirement could potentially become overburdening, they should voice such concerns when it comes time for the FIO to establish a rule designating the small insurer threshold.

Preemption Over State Insurance: In addition to information-gathering and reporting responsibilities, the FIO also has regulatory authority to "coordinate and develop federal policy on prudential aspects of international insurance matters." This authority includes helping the Secretary of the Treasury negotiate "covered agreements," which the Act defines as written or bilateral agreements regarding prudential measures with respect to insurance or reinsurance business between the United States and one or more foreign entities.

If any covered agreement conflicts with areas of state insurance law, (i.e., the state law results in more favorable treatment of the U.S. insurer over the foreign party to the covered agreement), the Act authorizes the director to notify and consult with the offending state and the United States trade representative regarding the inconsistency and the possibility of federal preemption. In making preemption determinations, the director is subject to the procedural rules in the Administrative Procedure Act, except that a court reviewing the appeal of any preemption decision does not have to give special credence to the director's determination, as is the case in other administrative appeals.

II. Non-admitted and Reinsurance Reform:

Title V also includes the Non-admitted and Reinsurance Reform Act, in which Congress focuses on streamlining state-level surplus lines and reinsurance regulation. This portion of the Act responds to complaints that the industry has long been plagued by a dysfunctional multi-state surplus lines tax system, as well as uncertainty regarding which state is the domiciliary state with jurisdiction over reinsurance contracts. The Act is divided into two parts: (1) surplus lines regulations, and (2) reinsurance regulations.

A. Surplus Lines Reform:

Although the surplus lines industry is referred to as an "unregulated" market, licensing and regulation are still important components in the non-admitted industry. The regulatory difference is that the admitted, or standard, carrier holds the license in the admitted market, whereas the surplus lines broker holds the license in the non-admitted market. The surplus lines industry also faces state regulation in the form of financial standing assessment and premium tax collection. Because premium tax collection and broker licensing standards vary from state to state, the surplus lines industry has complained of the marketplace inefficiencies inherent in subjecting the industry to non-uniform, multi-state regulations. In response to those complaints, the Act implements the following changes aimed at modernizing and standardizing regulations involving the surplus lines market:

Choice of Law: To clarify confusion among the industry players regarding which state's law will control non-admitted insurance disputes, the Act specifies that non-admitted insurance will be subject solely to the regulations in the insured's home state.

Surplus Lines Premium Taxes: The current state-by-state system requires surplus lines companies to make proportional premium tax payments to each state that is included in a multi-state policy. The new, simplified, system allows the state in which the insured is domiciled to have exclusive authority to collect premium taxes on non-admitted insurance. The insured's home state will then distribute the taxes according to a uniform system for premium tax allocations. The Act tasks the states with adopting nationwide uniform requirements for premium tax allocation and then requires the National Association of Insurance Commissioners to submit a congressional report identifying which states have complied.

Uniform Standards for Eligibility: Traditionally, surplus lines brokers could not do business with a non-admitted carrier unless that carrier was listed on the individual broker state's approved list of surplus lines insurance companies.[FN1] The Act standardizes the brokerage process and allows brokers to do business with any non-admitted insurer listed on the Quarterly Listing of Alien Insurers maintained by the National Association of Insurance Commissioners. The Act also stabilizes the regulatory landscape by requiring that any eligibility requirements imposed by the states must conform to the Non-Admitted Insurance Model Act.

Diligent Search Requirements: Traditionally, surplus lines brokers were required to perform diligent search efforts to obtain admitted insurance covering the types of risks sought by commercial purchasers before enrolling a non-admitted carrier. The Act eliminates this due diligence prerequisite, as long as the broker discloses that admitted insurance may be available to cover the risk sought and the commercial purchaser requests in writing that the broker obtains non-admitted insurance instead.

B. Reinsurance Reform:

Reinsurers have traditionally struggled under the U.S. state-based regulatory regime because the lack of uniformity among the reinsurance rules applicable in the 50 states produces heightened uncertainty in an otherwise-global market. With the following changes, the Act seeks to reduce this uncertainty by designating a single-state regulatory scheme:

Uniform Accreditation: The Act prohibits states from denying reinsurance credit if the home state of the insurer purchasing the reinsurance — or, the "ceding insurer" — meets the following requirements: (1) the home state is accredited by the National Association of Insurance Commissioners or has financial solvency ratings substantially similar to those necessary for NAIC accreditation, and (2) the home state recognizes a reinsurance credit for the ceded risk.

Regulatory Responsibility and Preemption: The Act bestows sole responsibility upon the ceding insurer's NAIC-compliant home state for regulating the financial solvency of the reinsurer. The preemption specification allows home-state regulations to trump all other state reinsurance laws to the extent those laws:

- Conflict with the home state's reinsurance laws;
- Conflict with the rights of the reinsurer and ceding insurer to invoke a contractual arbitration provision that is consistent with the Federal Arbitration Act;
- Conflict with the choice of law being designated as the home state of the ceding insurer; or
- Conflict with the terms of the reinsurance contract.

Financial Disclosure: The Act further prevents other states from requiring a reinsurer to provide financial information other than that required to be filed with its NAIC-compliant home state.

III. Next Steps:

With the addition of a new FIO and the implementation of new overarching initiatives in surplus lines and reinsurance reform, Congress has left many policy questions unresolved. But Congress *did* resolve that rulemaking and implementation should happen quickly — many of the congressional studies are due within a year of enactment, and the states must adopt their nationwide uniform requirements for premium tax allocation within two years of enactment. Therefore, to influence the shaping of this new insurance regime, it is essential to develop state and federal strategies for monitoring and influencing policy implementation on the outset of the rulemaking process. Components of such strategy would likely include:

Federal Strategy:

- ***Monitor Organization of Federal Insurance Office:*** Advocate for the appointment of a director who supports a similar level of being proactive as to your company; take measures to ensure that implementing rules conform with the congressional directive that the FIO retains no supervisory or regulatory authority.
- ***Defend Against Systemic Risk Assessments:*** Be prepared to ward off any accusation by the FIO that your company poses systemic risk to the U.S. financial market or the insurance industry. Such an accusation would expose your company to unprecedented federal oversight as a "nonbank financial company."
- ***Consult on Congressional Reports:*** In developing recommendations for its various reporting obligations, the FIO is required to consult with the industry and state regulatory agencies. Those companies that have a strong voice in the consulting process will likely set the agenda for the FIO's recommendations.

State Strategy:

- ***Regulation of International Insurance Matters:*** Congress has delegated preemption authority to the FIO on international insurance matters. The industry should closely monitor the FIO's state preemption activities and be prepared to challenge those preemptions when necessary.
- ***Data and Information Collection***: The FIO is required to exhaust information-gathering with state and federal regulatory agencies and public information sources before seeking information from the industry. Companies should work closely with state regulators to ensure that the FIO is not asking for duplicative or overlapping information from the industry. Small insurance carriers should also work to ensure that they fall within the small insurance exemption to be set by the FIO.

- ***Federal Oversight Recommendations:*** One of the FIO's main tasks is to assess whether the insurance industry is primed to advance toward more comprehensive federal oversight. Companies must work with state regulators to ensure that they have a voice in the direction of these recommendations.

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(Footnote 1) States have two years from enactment to begin participating in the NAIC's national insurance producer database or an equivalent, at which point they will not be entitled to collect any surplus lines brokerage fees until their enrollment in such a database.