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TREASURY DEPARTMENT'S BLUEPRINT FOR INSURANCE REGULATION OVERHAUL

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On March 31, 2008, in its "Blueprint for a Modernized Financial Regulatory Structure," the U.S. Department of the Treasury outlined a vision for overhauling the framework that regulates U.S. financial markets, including the insurance industry, to establish a more comprehensive and integrated system.**2** The Blueprint is a dramatic initiative that addresses federal versus state regulation of insurance and recommends the establishment of an optional federal charter for insurers and insurance producers. The proposed overhaul has international consequences and would empower the federal government to address any insurance issue deemed "international." While the Blueprint seems an ambitious effort to launch in the closing months of the Bush administration, the U.S. Congress has already been prompted to introduce legislation to address international issues and to harmonize state regulatory responses on the national level.

Overview of the Blueprint

The stated goal of the Blueprint is to introduce a more comprehensive approach to the regulation of the U.S. financial landscape. Because of their varying degrees of urgency, Treasury divided its recommendations into three distinctive categories to be implemented chronologically.
"Short-term" recommendations consist of the following:

• creation of a Mortgage Origination Commission to foster uniform minimum licensing qualification standards for mortgage industry participants;
• enhancement of the Federal Reserve's provision of liquidity, and access to lending through its discount window, to both depository and non-depository institutions; and
• expansion of the role of the President's Working Group on Financial Markets by adding the heads of the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision to the current members from Treasury, Federal Reserve, Securities Exchange Commission and Commodities Future Trading Commission.

While Treasury views the insurance industry as a major component of the financial services industry, none of the short-term recommendations listed in the Blueprint are specific to the insurance industry. Moreover, while the Blueprint argues for a major overhaul of the insurance industry as a critical component of the broader financial services market, it fails to recommend the addition of an insurance representative to the President's Working Group, and it does not address access to discount window**3** lending by non-depository institutions in the context of the insurance industry.

Treasury classifies its overhaul of the insurance regulatory framework as an "intermediate-term" goal, the most dramatic of which proposes an optional federal charter to be regulated by a new Office of National Insurance within Treasury. The Blueprint would also create the Office of Insurance Oversight that would have the authority to develop federal insurance regulations and positions on international regulatory issues, and coordinate the implementation of such regulations and positions with states and other countries. The Office of Insurance Oversight could be incorporated in the optional federal charter framework once insurance regulatory change is adopted by Congress. Other intermediate-term goals include:

• elimination of the Office of Thrift Supervision;
• determination of the appropriate federal supervisor of state-chartered banks;
• implementation of federal regulation of payment and settlement systems for the transfer of funds from financial institutions; and
• modernization of SEC regulation, followed by a merger of the CFTC and the SEC.

Henry M. Paulson, Jr., Secretary of the Treasury, concedes that implementing the intermediate-term recommendations, including the optional federal charter, could take between two to eight years.[4] Overall, Treasury views an objectives-based, in contrast to a rules-based, approach as the best way to reach the long-term "optimal regulatory structure" for the financial markets.[5] This approach would be implemented by the following four, newly-created regulators:

• Market stability regulator (the Federal Reserve) responsible for monitoring overall conditions of financial market stability that could impact the real economy, as well as collaborating with other regulators on rulemaking and taking corrective action when necessary in the interest of financial market stability.
• Prudential financial regulator responsible for the financial regulation of financial institutions, including establishing and monitoring capital adequacy, investment limits and other solvency related requirements.
• Business conduct regulator to handle consumer protection issues and standards for business practices across all types of financial institutions.
• Corporate finance regulator to assume the SEC's current authority regarding corporate oversight and accounting oversight.

Optional Federal Charter

The Blueprint advocates offering insurers the option to be regulated at the national level or under the current state system. Federal legislation would address the mechanics of obtaining a federal charter and licensing, regulation and supervision for federally chartered insurers, reinsurers and insurance producers.[6]

A newly created agency within the Treasury, the Office of National Insurance, would regulate federally chartered insurers. Insurers with federal charters would remain subject to "some continued compliance" with state laws, such as tax laws, compulsory workers' compensation, and individual auto insurance requirements, plus participation in residual risk mechanisms and guaranty funds. Rate regulation was intentionally excluded from those areas of regulation left to the states; as the Blueprint states "[w]hile numerous arguments have been made to justify such rate regulation, they are unpersuasive, especially since several states leave insurers largely free to set their own rates and Illinois does not have any rate regulation." [7] While the Blueprint calls for federal regulation of solvency issues regarding, and for a comprehensive scheme for the receivership of, federally chartered insurers, it would require federally chartered insurers to participate in state guaranty funds as well.[8]

Finally, the Blueprint would establish a federal insurance institution (FII) charter for insurers offering "retail consumer products with some type of government guarantee." Such products would include property insurance, personal automobile, life insurance and even certain commercial insurance products sold to small businesses.[9] While a FII charter would likely be "optional" (like the optional federal charter) for insurers, the Blueprint does not address the interplay between the FII charter and an optional federal charter.[10]

Insurance Information Act of 2008

On April 17, 2008, Representative Paul Kanjorski[11] introduced the Insurance Information Act of 2008[12], which would create a federal insurance oversight agency within the Treasury Department. Rep. Kanjorski's proposed legislation would create the Office of Insurance Information to collect and analyze data on insurance, advise the Treasury Secretary on major domestic and international policy issues, establish policy on international insurance matters, and coordinate the implementation of federal policy and international trade agreements with state regulators. The legislation is characterized as the first step toward the modernization of the U.S. insurance industry by building a source of knowledge and expertise regarding pressing domestic and international issues and developing a unified voice representing the U.S. insurance industry at the international level.

If passed, the Insurance Information Act of 2008 and the newly-created interim Office of Insurance Information would pave the way for the creation of the Office of Insurance Oversight as recommended by the Blueprint. The authority and role of the Office of Insurance Oversight would encompass and broaden those of the Office of Insurance Information. The Office of Insurance Oversight would preempt state laws or regulatory actions that are inconsistent with the international insurance policy established by the Office of Insurance Oversight. The Blueprint specifically refers to potential changes to reinsurance collateral requirements applicable to foreign reinsurers as an "international regulatory issue."[13] The Office of Insurance Oversight would also advise Treasury on insurance issues that affect financial markets such as financial guaranty insurance, private mortgage insurance and natural catastrophe insurance.

State vs. Federal Debate

The debate regarding the need for a federal regulatory regime applicable to the insurance industry has been ongoing. Proponents of an optional federal charter argue that the federal government and its relevant agencies are better equipped to address competition, market accessibility and pricing issues than the fifty states' regulators combined. Opponents believe states' regulators have the necessary knowledge and expertise to face the challenges facing the insurance industry, and, in particular, protect the consumer.

The proponents of federal regulation contend that a unified system would level the playing field and allow insurance companies to compete with banks and securities firms by bringing new products to the markets in a timely manner and offering a wider variety of insurance products to consumers. Opponents argue that insurance products are specific to local markets and that state regulators are more accessible and more responsive to a crisis than the federal bureaucracy.

The creation of an optional federal charter would not be the first time the federal government regulated some aspects of the insurance industry. The Liability Retention Risk Act of 1986 [14] created a new type of insurer, the "risk retention group," that could write insurance for its members in all fifty states while being subject to the laws of its charter state only. The Act preempted state laws that would hinder the formation and operations of risk retention groups in more than one state and any laws that would discriminate against a risk retention group or any of its members.

The Graham-Leach-Bliley Act[15] (GLBA) was a further example of the federal government's encroachment into the states' regulation of insurance. The GLBA established which insurance products banks and their subsidiaries could provide. It allowed national bank subsidiaries to distribute all types of insurance, and it preempted state laws interfering with bank affiliations. It also directed federal banking agencies to supervise the sale of insurance products by banks. Furthermore, GLBA threatened to impose a federal licensing scheme for insurance agents and brokers under a new National Association of Registered Agents and Brokers (NARAB), unless at least 50% of the states enacted a uniform producer licensing law by November 2002. This was accomplished by the deadline, thus avoiding the establishment of NARAB; as of year-end 2007, at least 35 states had enacted some version of the NAIC Producer Licensing Model Act. Nevertheless, there was still a sense that state licensing procedures lacked uniformity, and thus, in March 2008, federal legislation was introduced to once again establish NARAB. However, unlike GLBA, the proposed legislation[16] would make establishment of NARAB mandatory rather than conditional. NARAB would be created, regardless of further state efforts to create more uniform licensing procedures, as a private corporation (organized under the laws of the District of Columbia). Although producers would still need to obtain their resident licenses pursuant to the laws of their resident states, NARAB would license producers in all other states (i.e., NARAB would apply to nonresident producer licensing).

More recently, Congress passed the Terrorism Risk Insurance Act of 2002 to provide property and casualty insurers with a federal backstop program for catastrophic losses resulting from a terrorist act.[17]

Globalization of Insurance

The Blueprint goes beyond the traditional state versus federal debate about insurance and argues that the United States needs federal insurance regulation to allow its financial services markets to operate in a global economy. The insurance industry does not operate in a vacuum, but is part of the broader financial markets worldwide. The Blueprint argues that federal involvement is needed to provide a negotiating partner on the international stage and a policymaker on the domestic front. Regardless of one's views of the state versus federal debate, the Bush administration and some members of Congress note the international aspects of the insurance industry and the need to speak with one voice on issues such as collateral required from reinsurers domiciled outside the U.S. to allow for credit for reinsurance to the U.S. ceding company.

Arguably, state legislation regarding reinsurance and collateral requirements has an adverse impact on unauthorized foreign reinsurers. In April 2008, at the European Insurance Forum in Dublin, the issues of reinsurance collateral and the mutual recognition of regulatory systems between the U.S. and other countries were discussed.[18] At the same time, the lead regulator in the United Kingdom and the Chairman of Lloyd's complained of the slow pace of regulatory reform in the United States[19] and expressed frustration with the fragmented approach to insurance regulation in the biggest economy in the world. [20] The NAIC, through its Reinsurance Task Force, has been addressing the issue of reinsurance collateral[21], and, as of its meeting in March 2008, considered a proposal to regulate reinsurance based on three principles:

- A "Reinsurance Supervision Review Department" (established as a division of the NAIC) would decide which non-U.S. jurisdictions are allowed to enter into a mutual recognition agreement;
- Non-U.S. reinsurers from approved jurisdictions would select a single, "port of entry" state to apply uniform minimum standards; and
- U.S. reinsurers would submit to the jurisdiction of a single state regulator, eliminating extra-territorial regulations by other state regulators.

Other countries have long recognized the impact of globalization on the insurance industry. In the European Union, the Member States have recognized this trend and have been working for the past decade at creating a common regulatory regime. Various directives have been passed to harmonize the member states on solvency, reinsurance, competition and distribution, as well as financial standards. The debate is not whether uniform regulation is needed, but the content of the directives. Member states understand that these issues need to be resolved at the supranational level.22

Conclusion

The Treasury Department's Blueprint is an ambitious effort to steer the future regulation of the U.S. financial markets, including insurance. In addition to the optional federal insurance charter, the Blueprint contemplates an Office of Insurance Oversight to address international insurance issues. Representative Kanjorski's HR 5840 has introduced a similar entity- the Office of Insurance Information- to establish federal policy on international insurance matters and to ensure state insurance laws are consistent with federal policy. The creation of either office will send a strong message to the international community that the U.S. is intending to participate with other national insurance regulators to facilitate a consistent approach to insurance. Regardless of how the optional federal charter plays out, it would seem that all involved recognize that it is in the insurance industry's best interest to achieve a common approach for issues affecting the international arena.

It remains to be seen which, if any, of Treasury's ideas on insurance reform will be fleshed out and vigorously pursued, or if they will merely influence the ongoing political debate. Perhaps, the handling of international insurance issues will make it from "idea" to the finish line.

Endnotes

1. Kenneth R. Wylie, a partner with Sidley Austin LLP, acknowledges the assistance of Valerie Demaret-Fleming, an associate with Sidley Austin LLP, and Charlene C. McHugh, a counsel with Sidley Austin LLP, in the preparation of this article.

2. The Department of Treasury Blueprint for a Modernized Financial Regulatory Structure, Dept. of the Treasury (2008). http://www.treas.gov/press/releases/reports/Blueprint.pdf.

3. The Federal Reserve Discount Window is a program created in 1913 to provide, among other things, adequate liquidity in the banking system by allowing eligible institutions to borrow money at preferential rates on a short term basis. The official website is http://www.frbdiscountwindow.org/index.cfm

4. Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform (March 31, 2008), https://www.ustreas.gov/press/releases/hp897.htm.

5. Blueprint, at 137-138.

6. The National Association of Insurance Commissioners (NAIC) has voiced its opposition to an optional federal charter. NAIC Response to Treasury Report - Statement from NAIC President Sandy Praeger, March 31, 2008, http://www.naic.org/Releases/2008_docs/praeger_response_treasury_report.htm. Also see testimony of Eric Dinallo, New York Superintendent of Insurance, for a substantive defense of state regulation: Examining Proposals on Insurance Regulatory Reform, April 16, 2008 Hearing before the Subcomm. on Capital Mkts, Ins., and Gov't Sponsored Enter. of the House Comm. on Fin. Serv., 110th Congress (2008) http://www.house.gov/apps/list/hearing/financialsvcs_dem/ht041608.shtml.

7. Blueprint, at 129

8. Blueprint, at 130

9. Blueprint, at 167

10. *Id*. at 166. Products issued by FIIs would either remain covered by state guaranty funds or a newly-created federal insurance guaranty fund (FIGC) that would impose limits upon the amount of coverage recoverable by policyholders in the event of an FII's insolvency. If a FIGC is established, the FDIC would be reconstituted as the Federal Guarantee Corporation to oversee not only the deposit insurance fund, but also the FIGC.

11. Democrat - Pennsylvania and Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

12. H.R. 5840, 110th Congress (2008).

13. Blueprint, at 11

14. The Liability Risk Retention Act of 1986, Pub.L. No. 99-563, 100 Stat. 3177 (1986).

15. Gramm-Leach-Bliley Financial Services Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (Nov.12, 1999).

16. National Association of Registered Agents and Brokers Act, H.R. 5611, 110th Congress (2008).

17. Pub. L. No. 107-297 (Nov. 26, 2002) extended by The Terrorism Risk Insurance Extension Act of 2005, Pub. L. No. 10109-144 (Jan. 4, 2005) and The TRIA Reauthorization Act of 2007, Pub. L. No. 110-160 (Dec. 26, 2007).

18. M. Bradford, U.S. Treasury Moves to Reform Collateral Rules Welcomed, Business Insurance Europe, p.4, April 21, 2008.

19. International Developments in Insurance Regulation - Speech by Hector Sants, Chief Executive, FSA (April 8, 2008), available at http://www.fsa.gov.uk/pages/Library/communication/Speeches/2008/0408_hs.shtml.

20. Lloyd's Chairman, Peter Levene quoted a previously used definition of the NAIC, "No Action Is Contemplated." Chief UK Regulator attacks U.S. Collateral Rules, Best Wire Services (April 9, 2008).

21. Reinsurance Proposal Makes Progress, Provides Roadmap for Responding to Change in Marketplace, NAIC Press Release (Nov. 16, 2007), available at http://www.naic.org/Releases/2007_docs/reinsurance_proposal_progress.htm

22. As a further example, the International Association of Insurance Supervisors (IAIS) represents insurance regulators and supervisors from around the world. The IAIS works with other international organizations, including the European Union, to promote global financial stability, to address the issues that the insurance industry faces worldwide and to set best practices and standards for the insurance industry.