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FINANCIAL SERVICES MODERNIZATION: WHAT HAS THE NEW ADMINISTRATION SAID? WHAT WILL LIKELY HAPPEN AND WHEN?

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For those of you who missed NOLHGA's Legal Seminar in July in Chicago, the word "Loser" comes to mind. You missed a golden opportunity to get smart on receivership, guaranty association, and industry hot topics and to reap tons of CLE credits besides.

Several of the panels focused - and gave us smart tutorials - on financial services modernization. We're obviously in the midst of a vibrant debate over the shape of the insurance regulatory marketplace and have been for several years since Congress passed and President Clinton signed Gramm Leach Bliley in 1999. The Legal Seminar speakers gave the audience a bird's eye view of the pushes, pulls and prospects for action in this Congress and beyond. Here is a snapshot - but without CLE credits - of where we sit today on the legislative axis between the White House and Capitol Hill along Pennsylvania Avenue.

We have to start - and probably end, at least for this year - with Treasury's proposal for systemic financial regulatory reform announced June 17, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. It is expressly intended to "build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market." Notably, the proposal ventures into new areas that Treasury has not previously addressed, including insurance regulation. While the proposal does not go so far as to push a federal charter for insurance companies, it potentially subjects certain insurers to greater federal regulation and leaves the door open for more. In this summary, we will briefly outline the proposal's five stated objectives and then highlight what all of this could mean for insurers and insurance holding companies. We'll not dwell very much on the more extensive banking elements of the proposal, except to the extent they implicate insurance.

REFORM OBJECTIVES

The proposed reforms are on a fast track. Many elements of the plan can be accomplished under current law and, therefore, have mandated deadlines that occur in 2009. Other elements of the proposal require the passage of new legislation, which will be key in understanding the actual breadth and depth of Treasury's proposals, but Treasury has instructed regulators to start planning for such legislation even as the debates rage in Congress.

- **Systemic Supervision.** Treasury seeks to establish strong regulatory oversight of any financial institution that is deemed critical to market functioning. The authority of the Federal Reserve Board ("FRB") would be expanded, making it the single point of accountability for supervision of all companies that pose a threat to financial stability, even those that do not own a bank. That element of the plan is probably the most controversial politically, since many legislators have expressed reservations about ceding more power to the FRB.
 - ◆ Treasury will establish the Office of National Insurance ("ONI") to gather information, develop expertise, negotiate international agreements and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve the current system of insurance regulation. As influential industry commentator Karen Shaw Petrou summed it up,

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"ONI's responsibilities would generally be advisory and focused on systemic risk, but it would gather data from covered insurers and have express authority to preempt state insurance rules found inconsistent with international prudential agreements and to negotiate in this area on behalf of the United States."

- ◆ A Financial Services Oversight Council, chaired by Treasury and comprised of the heads of certain financial regulatory agencies, will advise the FRB regarding emerging systemic risks and settle jurisdictional disputes among the regulators. As proposed, the Council will not include the ONI (except derivatively through Treasury's seat), the NAIC or any state insurance regulator. (The NAIC is working to obtain a seat on the Council representing state regulators.) The Council would maintain a permanent staff at Treasury.
 - ◆ The FRB will directly supervise and regulate each large, interconnected, highly leveraged firm that it deems (in consultation with the Council) a potential threat to systemic financial stability (called Tier 1 Financial Holding Companies or "Tier 1 FHCs"), regardless of whether the firm owns a bank.
 - ◆ Treasury will lead a working group to assess the supervision of and capital requirements for banks and bank holding companies, as well as firms identified as Tier 1 FHCs.
 - ◆ Treasury proposes the creation of a new federal agency, the National Bank Supervisor ("NBS"), to supervise and regulate all federally chartered depository institutions and all branches and agencies of foreign banks. The federal thrift charter will be eliminated; the NBS will assume the responsibilities of the Office of the Comptroller of the Currency and for the institutions currently supervised by the Office of Thrift Supervision. Alternative charters currently enjoyed by certain banking entities, including industrial loan companies, would be curtailed.
 - ◆ All firms that control a bank will be subject to supervision and regulation by the FRB and will be subject to the nonbanking activity restrictions of the Bank Holding Company Act.
 - ◆ The proposal establishes revised regulatory structures for investment banking firms, hedge funds and other private pools of capital, money market mutual funds and government sponsored enterprises (Fannie Mae and Freddie Mac).
- **Market Regulation.** Treasury proposes to establish comprehensive regulation of securitization markets, OTC derivatives (including credit default swaps) and "systemically important payment, clearing and settlement systems." (The Administration offered legislative language on OTC derivatives on August 11, 2009.)
 - **Consumer Protection.** Treasury proposes the formation of an independent agency (the "Consumer Financial Protection Agency" or "CFPA") to regulate firms that provide credit, savings, payment and "other consumer financial products and services," including banks and "other firms not previously subject to comprehensive federal regulation." Notably, investment products and services already regulated by the SEC or CFTC are excepted out of CFPA oversight, but there was no such exception for insurance products regulated by the states. However, the legislation sent to the Hill on June 30 was clearer on that point, and it looks like virtually all insurance products (except for credit, mortgage and title insurance) would be outside the CFPA's jurisdiction. The rules established by the CFPA would set a federal floor to be enforced by the states, which would also have the ability to adopt stricter laws.
 - ◆ The CFPA will set forth new disclosure standards, requiring such communications to be reasonable, balanced, clear and conspicuous in the identification of risks.
 - ◆ "Plain vanilla" products will be subject to different standards than complex products. Firms will be required to offer a mix of such product types.
 - ◆ The SEC will have expanded authority to protect investors through transparent disclosures, new requirements for broker-dealers and investment advisors and expanded protection for whistleblowers.

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- **Crisis Management**. Treasury proposes the creation of a resolution regime for the orderly resolution of failing bank holding companies, including Tier 1 FHCs, modeled after the existing Federal Deposit Insurance Act. This resolution authority would be limited to those firms whose failure puts the stability of the financial system at risk; in all other instances, bankruptcy would remain the preferred resolution option. The costs associated with the systemic risk resolution regime would be paid by assessments on bank holding companies.
- **International Standards**. Treasury will seek to strengthen the international capital framework, improve the oversight of global financial markets, enhance supervision of internationally active financial firms and reform crisis prevention and management authorities and procedures.

IMPACT ON THE INSURANCE INDUSTRY

Except for a few specific references, insurance gets scant express attention in the proposal. In fact, only two out of the 88 pages that set forth the reform proposal are dedicated to the insurance industry. However, much of the language of the proposal is broad enough that insurance could be swept into several of the initiatives. In those instances, we will have to await further development of the proposal before we know the exact impact on the insurance industry; some of the initial House and Senate hearings have already touched insurance.

- **Systemic Supervision**. There are three primary elements of systemic supervision that could impact insurance companies or their holding company systems - the establishment of the ONI, the identification of Tier 1 FHCs, and the closure of perceived loopholes in bank regulation.
 - ◆ **Office of National Insurance**. Treasury seeks to create the ONI in order to monitor all aspects of the insurance industry and be responsible for identifying any trends or gaps that could give rise to a future crisis, but does not ascribe any regulatory authority to the ONI. (In fact, the proposal mirrors Congressman Paul Kanjorski's Insurance Information Act of 2009, H.R. 2609, which earlier called for the establishment of a federal Office of Insurance Information.) Additionally, the ONI would recommend to the FRB any insurance companies or insurance holding company systems that it believes should be deemed to be Tier 1 FHCs. Further, in the international arena, the ONI would be the single regulatory voice of the U.S. insurance industry, wielding the authority to enter into international agreements.

Treasury's proposal does not suggest displacing the current state-based system of regulation in exchange for a federal regulator. Instead, Treasury will support proposals to "modernize and improve" the current system of insurance regulation, consistent with six principles:

- ◇ *Effective systemic risk regulation* - Treasury will consider additional regulation, beyond the scope of the current proposal, if that would help further reduce systemic risk.
- ◇ *Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies* - Any new insurance regulatory regime should include strong capital standards and appropriate risk management.
- ◇ *Meaningful and consistent consumer protection for insurance products and practices* - Any new insurance regulatory regime should enhance existing consumer protection and address any gaps or problems under the existing system.
- ◇ *Increased national uniformity through either a federal charter or effective action by the states* - Increased consistency in the regulation of insurance should enhance financial stability, increase economic efficiency and result in real improvements for consumers.

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- ◇ *Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business* - Any new regulatory regime should address gaps in current insurance holding company regulation that permit non-insurance affiliates to threaten the solvency of the insurance companies.
- ◇ *International coordination* - Improvements to the existing system of insurance regulation should enhance the international competitiveness of the American insurance industry.

- ◆ **Identification of Tier 1 FHCs.** Large insurance holding companies will be considered for Tier 1 FHC status. (After all, the AIG meltdown is a primary impetus behind forming a systemic risk regulator.) In order to recommend to the FRB certain firms that should be identified as Tier 1 FHCs, the new Financial Services Oversight Council will have authority to require periodic reports from any U.S. financial firm that meets minimum size thresholds yet to be established, including insurers and insurance holding companies. The proposal invites legislation that would set forth specific factors that the FRB must consider in identifying Tier 1 FHCs. A firm deemed to be a Tier 1 FHC will be subject to heightened regulation by the FRB with respect to capital, liquidity and risk management, among other things. The FRB would also have authority to require reports from, conduct examinations of and address systemic risk concerns with respect to all subsidiaries of a Tier 1 FHC, including those that have another primary functional regulator (such as insurance companies).
- ◆ **Closure of Bank Regulation Loopholes.** Currently, under the Bank Holding Company Act ("BHCA"), any company that owns a bank must register as a bank holding company and is subject to supervision and regulation by the FRB. However, certain firms, including insurance holding company systems (such as AIG), have taken advantage of perceived loopholes in the BHCA by which certain depository institutions are not deemed to be "banks;" they have, therefore, avoided certain restrictions and regulation under the BHCA. The Treasury proposal seeks to close such loopholes and would bring firms that own a depository institution under greater regulation by the FRB and would give them five years to come into compliance with the nonbanking activity restrictions of the BHCA.

- **Consumer Protection.** Treasury's proposal suggests that the jurisdiction of the CFPA will extend to firms that provide "other consumer financial products and services," without explanation of how broadly this language will be applied. Treasury officials initially indicated that no decision had been made whether insurance products would be subject to the authority of the CFPA. When asked if the CFPA's authority would extend to the sale of annuities and homeowner's insurance, Treasury Secretary Geithner explained that the Administration is "redrawing the boundaries of authority" for consumer protections and that "not all products respect these boundaries neatly." The legislation sent to the Hill on June 30, however, specifically excluded from its scope the "business of insurance ... other than with respect to credit insurance, mortgage insurance or title insurance."
- **Crisis Management.** Treasury's proposal contemplates a resolution regime that would allow for the orderly resolution of firms whose failure threatens the stability of the financial system. This resolution authority could be invoked only after consultation with the President and upon written recommendation by two-thirds of the members of the FRB and of the FDIC Board (or the SEC, if the bank holding company or an affiliate is a registered broker or dealer). If a failing firm includes an insurance company, the ONI would consult with the FRB and FDIC Board on insurance specific matters. Treasury would generally appoint the FDIC as receiver of the holding company, but the proposal specifically preserves state law consumer protections provided to insurance policyholders. (Treasury's proposed legislation makes clear that the FDIC's resolution authority would not extend to insurance companies.)

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WHAT'S HAPPENED SO FAR

Three pieces of specific legislation touching insurance have been sent to the Hill by Treasury pursuant to the Administration's plan - the consumer protection proposal embodied in the Consumer Financial Protection Agency Act of 2009, the systemic supervision proposal which includes the new Office of National Insurance within Treasury, and the proposal for regulating over-the-counter derivatives. Hearings on all this have started, even though the Congress has been preoccupied by cap and trade and then health insurance/care reform.

In both chambers, Members have expressed fulsome disagreement over giving the FRB more power, over layering a new consumer protection bureaucracy on top of existing regimes, and over the extent to which "reg reform" is needed at all as the economy starts to pull out of the depths of the 2008 meltdown.

WHERE FROM HERE?

How much reform/change are we in for? Where are the battles forming in the Congress and around what?

The continuing economic problems, deepening in the first quarter and fueled by the AIG bonus and other controversies, certainly put Congress in the mood to do something, and the House has been pushing for that "something" more than the Senate. The economic improvement the past three months has eased the drum beat for action a little, but we continue to hear from the leading edge of people urging Congress to respond in some way to the economic crisis, particularly if things get worse. The Administration's plan will frame the debate, although the press of so many other compelling issues means it is not a certainty that House Financial Services Committee Chairman Barney Frank's prediction that the President will have regulatory reform legislation by the end of the year will happen. Chairman Frank cannot control what happens in the more leisurely Senate this fall where the Senate Banking Committee under Senator Chris Dodd is in the lead.

Insurance companies - and the solid consumer protections that apply when they go broke - will likely be in that debate, if not this year, then in the future. And the proponents of optional federal chartering will be offering their proposals, including the Bean/Royce bill introduced in April (the National Insurance Consumer Protection Act, H.R. 1880). What happens if the stress in the variable market continues for the foreseeable future? What happens if one, two or more top 25 life companies actually fail? Can the current guaranty system handle that? We know so, but we have to state it, explain it and defend it as several speakers did so eloquently at the NOLHGA Legal Seminar in July in Chicago.

The guaranty association story was not until recently, and probably in a few quarters still is not, completely understood in Congress. The system has done its job of protecting consumers for 40 years, and the capacity of that system is robust. Plus, what happens in an insurance insolvency - replacing insurance policy promises from a failed carrier going out decades with better promises from solvent carriers - is so much different than what is done when a bank fails - replacing cash with cash over a week-end - that it hardly seems logical even to consider an FDIC- type safety set - but that is the comparison.

Does anyone think that we don't need to be able to respond clearly and competently to guaranty capacity inquiries in the context of questions about potential top-25 insurance company failures? Does anyone think that given the speed with which the federal regulators have acted in this crisis, generally, and as to AIG, specifically, that the insurance insolvency and guaranty systems are not going to be in for constant timing comparisons from here on out? And, finally, with taxpayer dollars at risk in AIG, and with TARP funds now going to at least two insurance companies, does anyone seriously doubt that the federal government will be ever more interested in the industry and all of its aspects, including the insolvency safety net? And with FDIC limits going up to \$250,000, does anyone doubt that there will be pressure to increase GA limits and continuing comparisons with the FDIC limits and operations?

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In short, we were always going to see the current guaranty system put under a microscope if there were major insurance failures or strains while the financial services reform and OFC debates pend - or, after a new federal insurance office gets going in Treasury. We can't ignore the changed atmosphere and cling to the hope that Congress or the Administration won't at least look at us hard.

Congress has the power to sweep state receiverships and state guaranty associations out of the way, at least for federally regulated insurance entities if such there ever is, and the federal regulator we get in today's environment may look a whole lot different - and less "optional" - than the one we might have gotten from the last Congress and Administration. That's why we need to keep pointing out that the guaranty system's 40-year track record, coupled with the research, stress testing and analysis we've done, show clearly that ditching the rock solid and time- tested guaranty system safety net would be the worst thing for insurance companies and their policyholders, however regulated, not to mention U.S. taxpayers.
