THE PRINCIPAL PROVISIONS OF THE DODD-FRANK FINANCIAL REFORM BILL AFFECTING INSURANCE AND REINSURANCE

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Summary

The recently enacted financial regulation reform bill, the Dodd-Frank Act ("DFA"), contains many provisions that may affect the business of insurance and reinsurance. This Special Focus article addresses provisions of the DFA primarily relating to the insurance and reinsurance industries. Although the DFA contains relatively few provisions that apply specifically to reinsurance companies, provisions that apply specifically to the insurance industry may have an indirect impact on reinsurance arrangements or reinsured risks.

The DFA: (1) substantially preserves the primacy of the existing state regulation of insurance; (2) provides for a limited federal role with respect to insurance and reinsurance through the Federal Office of Insurance ("FIO"); (3) provides a substantial role for the federal government with respect to international insurance and reinsurance matters; and (4) establishes federal rules for allocating responsibilities among states for some issues with respect to surplus lines and reinsurance. The National Association of Insurance Commissioners ("NAIC") secured a limited role with respect to international issues with the requirement that the FIO consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance. The extent to which the NAIC will continue to be active with the International Association of Insurance Supervisors is unclear given the fact that the FIO has been tasked with representing the United States in that organization.

It is unclear the extent to which the DFA intends to "carve out" the regulation of reinsurance for states, in part because of the limited existing regulation of reinsurance by states. There are, to the contrary, portions of the DFA that directly regulate the reinsurance market and reinsurance activities, and the DFA calls for a comprehensive study of the reinsurance markets, which may form a predicate for federal regulation of reinsurance. The extent to which this may be contemplated is unknown.

Analysis

I. General provisions of the DFA which may apply to insurance and reinsurance companies and markets.

In addition to provisions of the DFA which apply only to the insurance or reinsurance industries, certain provisions of the DFA apply to nonbank financial companies, which may include insurance or reinsurance companies. For example, nonbank financial companies that are deemed to pose certain systemic risks to the national economy may be subject to enhanced prudential regulation by the Federal Reserve ("the Fed"), upon a determination by the Financial Stability Oversight Council ("the Council") that such regulation should occur. A state insurance regulator will be a non-voting member of the Council, and hence may have some input on issues relating to insurance companies. Prior to making such a determination with respect to an insurance company, the Council would consult with the company's primary regulator, presumably the insurance commissioner of its domiciliary state. Such enhanced prudential regulation could include financial requirements, a restructuring of the operations of the company or directives that they not issue certain insurance products. In an extreme case, such companies may be placed in liquidation, although with respect to an insurance company, such liquidation would occur under the existing state-based insurance company insolvency scheme.

II. Provisions of the DFA which may apply specifically only to insurance and reinsurance companies and markets.

A. The Federal Insurance Office

The DFA establishes a Federal Insurance Office ("FIO") within the Department of the Treasury. The Secretary of the Treasury ("the Secretary") is tasked with appointing the Director of the FIO. The functions of the FIO are to:

- monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system;
- monitor the extent to which traditionally underserved communities and consumers, minorities, and low and moderate-income persons have access to affordable insurance products (for all insurance lines except health insurance);
- recommend to the Financial Stability Oversight Council ("Council") when it should designate an insurer, including its affiliates, as an entity subject to regulation as a nonbank financial company subject to enhanced prudential regulation by the Fed;
- assist the Secretary in administering the terrorism insurance program under the Terrorism Risk Insurance Act of 2002;
- coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors and assisting the Secretary in negotiating international agreements regarding prudential measures with respect to the business of insurance or reinsurance;
- determine whether state insurance measures are preempted by such international agreements (*see* subpart B, below); and
- consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance.

The FIO also has two advisory functions, namely to advise the Secretary on major domestic and prudential international insurance policy issues; and to serve, through its Director, in an advisory capacity on the Council.

The FIO is given no authority with respect to: (1) health insurance; (2) long-term care insurance, except long-term care insurance that is included as part of a life insurance or annuity policy; and (3) crop insurance, as established by the Federal Crop Insurance Act. These are broader exclusions than those previously proposed by the Obama Administration.

The DFA requires that the Secretary consult with state insurance regulators, individually or collectively, to the extent determined appropriate by the Director in carrying out the functions of the FIO. However, the DFA specifically limits the authority of the FIO in all of its activities such that the FIO provisions would <u>not</u>:

- preempt any state insurance measures that govern an insurer's rates, premiums, underwriting or sales practices;
- preempt any state coverage requirements for insurance;
- preempt the application of the antitrust laws of any state to the business of insurance;
- preempt any state insurance measure governing the capital or solvency of an insurer, except to the extent that such measure results in less favorable treatment of a non-United States insurer than a United States insurer (although later provisions of the DFA outside the FIO provisions, such as those described below dealing with credit for reinsurance, would have an impact on capital and potentially the solvency of ceding insurers);
- be construed to alter, amend, or limit any provision of the Bureau of Consumer Financial Protection provisions (which generally lacks authority with respect to the business of insurance and insurance products);
- 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;
- be construed to limit the authority of any federal financial regulatory agency;
- limit the authority of the United States Trade Representative; or
- affect the preemption of state insurance measures preempted by other federal law.

B. <u>International Agreements and Preemption of State Insurance Measures</u>

The DFA authorizes the Secretary and the United States Trade Representative jointly to negotiate and enter into international insurance agreements on prudential measures on behalf of the United States. It also authorizes the FIO's Director to conclude that a state insurance measure is preempted by federal law if the Director finds that the state measure (i) treats an insurer that is domiciled outside the United States and subject to an international agreement on prudential measures less favorably than it treats a United States insurer domiciled, licensed or otherwise admitted in that state, and (ii) is inconsistent with such international agreement. One of the goals in requiring such a review is to "achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation." This recognition of the interests of reinsurance consumers reflects the DFA's general pro-consumer approach, although it is unclear what state regulation of reinsurance might be contemplated.

Prior to making such a preemption determination, the DFA requires the Director to: (i) notify and consult with the appropriate state and the United States Trade Representative; (ii) publish notice in the Federal Register regarding the potential inconsistency or preemption; and (iii) provide a period for written comments by interested parties, and consider any comments received. A preemption determination would not be effective earlier than 30 days after the notification of the effected state of the determination. Once such a determination is final, and notice of the finality is published in the Federal Register, no state would be able to enforce a state insurance measure to the extent that the measure has been preempted.

Before initiating negotiations of any such international agreement, the Secretary and United States Trade Representative must jointly consult with identified Congressional committees as to the nature of the proposed agreement, how and the extent to which the agreement would achieve the applicable purposes, policies, priorities and objectives of the applicable section of the DFA, and the implementation of the agreement, including the general effect of the agreement on existing state laws. The final text of any such agreement must be submitted to Congress at least 90 calendar days prior to its effectiveness.

The preemption provisions of the DFA are specifically limited to the subject matter of the international agreement and the need to achieve a level of protection for insurance and reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation. Moreover, in addition to the general limits on the authority of the FIO outlined above, the DFA contains specific limitations on the preemptive effect of any international agreement with respect to: (i) any state insurance measure that governs any insurer's rates, premiums, underwriting or sales practices; (ii) any state coverage requirements for insurance; (iii) the application of the antitrust laws of any state to the business of insurance; or (iv) any state insurance measure governing the capital or solvency of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a non-United States insurer than a United States insurer (subject to the credit for reinsurance provisions outlined below).

The DFA expressly provides that neither the FIO nor the Department of the Treasury has "general supervisory or regulatory authority over the business of insurance." It appears that the DFA does not intend to preempt the regulation of the business of insurance by the states other than in the context of establishing and implementing federal policy with respect to the prudential regulation of insurance on an international scale.

C. Information Gathering, Studies, and Reporting

The DFA provides the FIO with the authority to gather and analyze information reasonably required in carrying out its functions, through cooperative information sharing arrangements with state insurance regulators, requests to insurers or their affiliates, and by subpoena. Reinsurance companies are subject to this information gathering and analysis process, since for purposes of this section only, "insurers" is defined as "any entity that writes insurance or reinsures risks and issues contracts or policies in 1 or more states." There is no general definition of "insurer" in the DFA, so it is unclear whether the term "insurer" includes reinsurers for purposes of other provisions of the DFA.

Information may not be gathered directly from an insurer or affiliate that meets the minimum size threshold established by the FIO by rule. To further reduce the burden on insurers, information may be obtained from an insurer *only* if the information is not available from federal or state regulatory agencies or other publicly available sources. The provision of non-public information by insurance companies will not constitute a waiver of any privilege available under federal or state law, and shall not affect any existing confidentiality laws or agreements. The FIO may establish an information sharing agreement to share information it has with state insurance regulators. Subpoenas may be issued only for information not otherwise available, and after coordination with state regulatory authorities.

The DFA requires that the FIO's Director provide reports as follows:

- Annual reports to the President and to Congress regarding: (1) any preemption of state insurance measures implemented by the FIO; and (2) the insurance industry and any other information deemed relevant by the Director, or as requested by the Congressional committees;
- A report to certain Congressional committees no later than September 30, 2012 describing the breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the United States. Although the purpose of this study is not specified, many studies of this type provided for in the DFA appear to be designed to provide facts and recommendations to Congress for the consideration of further regulation of the subject matter of the study;
- A report to certain Congressional committees no later than January 1, 2013 (and updated not later than January 1, 2015), describing the impact of Part II of the Nonadmitted and Reinsurance Reform Act of 2010 (*see* subpart D below) on the ability of state regulators to access reinsurance information for regulated companies in their jurisdictions;
- A report resulting from a special one-time study on how to modernize and improve the system of insurance regulation in the United States. This report would contain any appropriate legislative and regulatory recommendations, and would be provided to Congress not later than 18 months after the enactment of the DFA. In conducting

the study, the FIO would be required to consult with the NAIC, consumer organizations, representatives of the insurance industry, and policyholders. In this connection, the FIO would be required to consider the following factors:
  - systemic risk regulation;
  - capital standards;
  - consumer protection for insurance products and practices;
  - 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;
  - the costs and benefits of potential federal regulation across various lines of insurance (except health insurance);
  - the feasibility of regulating only certain lines of insurance at the federal level;
  - the ability of any potential federal regulation or regulator to eliminate or minimize regulatory arbitrage;
  - the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance;
  - the ability of any potential federal regulation or regulator to provide robust consumer protection for policyholders; and
  - the potential impact of subjecting insurance companies to a federal resolution authority on (i) the operation of state insurance guaranty funds, (ii) policyholder protection, (iii) separate account issues, and (iv) international competitiveness.

D. <u>Nonadmitted and Reinsurance Reform Act of 2010</u>

The DFA also contains a version of proposed legislation that has been introduced in Congress as separate bills at least since 2006. This portion of the DFA has not been controversial. The language in both the House Bill and the Senate Bill were the same, and no significant changes were made in the conference committee.

The DFA contains the following provisions with respect to nonadmitted insurance:

- establish a "home state" for insureds for purposes of this portion of the DFA, namely the state in which the insured maintains its principal place of business; except that, if 100% 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;
- premium taxes:
  - provide that no state other than the home state of an insured may require the payment of any premium tax for nonadmitted insurance;
  - provide that states may enter into a compact or other procedures for the allocation of nonadmitted premium tax revenues among the states;
  - require that the NAIC submit a report to Congress identifying and describing any such interstate compact or other procedures for allocating premium taxes among the states; and

    - encourage the adoption by each state of nationwide uniform requirements, forms, and procedures for reporting, payment, collection, and allocation of such taxes;
- provide that the placement of nonadmitted insurance shall be subject to regulation solely by the insured's home state;
- after a two-year exemption period, prohibit the collection by states of fees relating to the licensing of an individual or entity as a surplus lines broker unless the state participates in a national insurance producer database (whether under the sponsorship of the NAIC or otherwise);
- prohibit a state from establishing eligibility requirements for United States-domiciled nonadmitted insurers that vary from the provisions of the NAIC's Non-Admitted Insurance Model Act;
- prohibiting a state from prohibiting a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, a nonadmitted non-United States domiciled insurer that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC;
- restrict the ability of states to require surplus lines brokers seeking to procure or place nonadmitted insurance for an exempt commercial purchaser (a term subject to a multi-part definition) to make a due diligence search to determine whether the full amount or type of insurance sought by such exempt commercial purchaser can be obtained from admitted insurers, under specified circumstances; and
- require a GAO study of the nonadmitted insurance market, in consultation with the NAIC, covering:
    - the change in the size and market share of the nonadmitted insurance market and in the number of insurance companies and insurance holding companies providing such business over an 18 month period of time;
    - the extent to which insurance coverage typically provided by the admitted insurance market has shifted to the nonadmitted insurance market;
    - the consequences of any change in the size and market share of the nonadmitted insurance market, including differences in the price and availability of coverage available in both the admitted and nonadmitted insurance markets;
    - the extent to which insurance companies and insurance holding companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted markets; and
    - 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 insurance market.

The reasons for the GAO study of the nonadmitted market are not stated, but the DFA is the initial foray of Congress into regulating the nonadmitted insurance market. It is logical to assume that the GAO study may form part of a future assessment of whether additional federal regulation of the nonadmitted insurance market is necessary and appropriate.

With respect to reinsurance, the DFA will:

- Provide that, if the state of domicile of a ceding insurer (so long as the state is NAIC accredited) recognizes credit for reinsurance for the insurer's ceded risk, no other state may deny such credit for reinsurance;
- Except those with respect to taxes and assessments on insurance companies and insurance income, preempt the extraterritorial application of the law of a state to a ceding insurer not domiciled in that state to the extent that such laws:
  - restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration consistent with the provisions of Title 9 of the United States Code;
  - require that a certain state's law shall govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;
  - attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract, to the extent that the terms are not inconsistent with this portion of DFA; or
  - otherwise apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in that state; and
- Provide that if the state of domicile of a reinsurer is an NAIC accredited state, or has financial solvency requirements substantially similar to those required for NAIC accreditation, that state shall be solely responsible for regulating its financial solvency, and no other state may require the reinsurer to provide any additional financial information other than what the reinsurer is required to file with its domiciliary state.

These provisions may be significant for drafting reinsurance contracts, since they make the law of the ceding state control over the law of other states, and seem to prevent state laws from overruling contractual provisions consistent with the DFA. While these provisions do not expressly prohibit the parties to a reinsurance contract from agreeing that a reinsurance contract shall be governed by the law of a state other then the state of domicile of the ceding insurer, it might be open to question whether the parties could do so by contract.

Conclusion

In many respects, the DFA is an important first step by the federal government into the regulation of the business of insurance and reinsurance, areas which traditionally have been the province of the states, particularly since the enactment of the McCarran-Ferguson Act. Indeed, the relationship between the insurance provisions of the DFA and the McCarran-Ferguson Act may prove to be interesting. Only time will tell what the impact of these provisions will be on the insurance and reinsurance industries.

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