Legal Backgrounder

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Regulating International Insurance Companies: A "Camel's Nose" For Federal Regulation?

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The recent global financial crisis demonstrated the interdependence of our industrial society in stark tones. Who would have thought that packaged sub-par mortgages sold in the U.S. could bankrupt small towns in Norway, or that traders playing fast and loose with credit default swaps in London could threaten the solvency of one of the world's largest insurance companies? Leaders of the major industrial nations (collectively the G-20) have vowed to make sure it can't happen again. They have agreed to establish tough solvency standards and to hold the largest financial institutions operating across national borders to those standards, whether banks, investment companies, insurers, or combinations thereof.

There is a small hitch: The U.S. Government, which directly regulates large banks and securities dealers, has no comparable authority over the business of insurance. For historical reasons, insurance in the U.S. has always been regulated by the states. The McCarran-Ferguson Act of 1945[1]—enacted shortly after the U.S. Supreme Court determined that the business of insurance is interstate commerce—declared that the states would continue to exclusively regulate insurance. The Dodd-Frank Act of 2010,[2] designed to tighten regulatory standards for large financial institutions, created a number of new entities, including the Federal Insurance Office (FIO), an office within the Treasury Department responsible for monitoring the insurance industry. But Dodd-Frank specifies that the FIO is *not* a regulatory agency, and that insurance shall continue to be regulated by the states. Dodd-Frank at § 313(k). As a result, the U.S. Government has had a tough time explaining to its partners in the G-20 how it can carry out its commitment to support and enforce international fiscal standards for large multi-national insurance companies.

Dodd-Frank, while leaving the states in charge of regulating insurers, contains several exceptions to that general rule. These exceptions, though very narrow and strewn with formidable obstacles, nevertheless give federal officials some potential tools for using the might of the U.S. Government to hold large insurers to international solvency standards. This Legal Backgrounder describes those small loopholes, assesses their potential for the exercise of federal power, and describes the steps already under way by the U.S. Government to exploit them. Those efforts are being strenuously resisted by state insurance regulators and their national organization, the National Association of Insurance Commissioners (NAIC), by state legislators and the National Conference of Insurance Legislators (NCOIL), and by Members of Congress who oppose the expansion of federal authority at the expense of the states. Will the exceptions be able to swallow the rule? Is the FIO the "camel's nose under the tent" that will lead to a major expansion of Federal Government authority over the business of insurance? Those are the questions that make the usually obscure topic of insurance regulation a hot item.

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[1] Ch. 20, § 1, 59 Stat. 33 (1945) (codified at 15 U.S.C. § 1011).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1002, 12A Stat. 1376 (2010). (Hereafter Dodd-Frank.

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Exception 1: Systemically Important Financial Institutions (SIFIs). In addition to creating the FIO, Dodd-Frank also established the Financial Stability Oversight Council (FSOC), which is charged with determining which U.S.-based financial organizations are so large and so ubiquitous in their operations that their failure would pose a significant risk to the entire financial system. *Id*. at § 101. A company designated a "SIFI" is to be regulated by the Federal Reserve Board. While aimed primarily at large banks and investment firms, the provision applies to insurance companies as well. Any U.S.-based insurance company that is determined by FSOC to pose a systemic risk to the financial system becomes subject to the authority of the Federal Reserve Board. So far FSOC has designated two major U.S. insurers as SIFIs, AIG and Prudential. MetLife and Berkshire Hathaway are currently under consideration. How far will FSOC take its authority? Are all large U.S. insurers that operate internationally potentially exposed to dual regulation—by the Federal Reserve Board and their state regulators? And what, exactly, will regulation by the Federal Reserve Board mean?

This unprecedented authority for the Federal Government raises a number of major questions. The Federal Reserve Board is given authority over SIFI-designated insurance companies that are also subject to regulation by state insurance commissioners. Does the Federal Reserve Board have the power to overturn or supersede decisions made by state regulators? If state and federal regulators disagree, which regulator has the final word? Can the Federal Reserve Board demand that higher capital be maintained by a designated SIFI insurance company that has been found by its state regulators to be adequately capitalized? If the Federal Reserve Board can demand higher capitalization for a SIFI insurance company, can it also change the rates and forms used by the SIFI whose forms and rates have already been approved by state regulators? If a SIFI is required by the Federal Reserve Board to maintain a higher level of capitalization than its major competitors, is it placed at a competitive disadvantage in the marketplace?

Dodd-Frank requires that nonbank SIFIs be subject to standards and requirements that are "more stringent" than companies that "do not present similar risks to the financial stability of the United States." *Id*. at §165 (a)(1)(a). This includes establishing "liquidity requirements," "overall risk management requirements," and "concentration limits." *Id*. at §165(b)(1)(A)(ii),(iii) & (v).

The Act also provides that FSOC make recommendations to the Federal Reserve regarding what prudential standards should be imposed on SIFIs. FSOC may also recommend "new or heightened standards and safeguards" to the primary financial regulators of financial institutions. *Id*. at §112(2)(K). For insurance companies that would be their state insurance commissioners. Those recommendations may be made to not only address systemic risk but also activities that may impact "low-income, minority, or underserved communities." In the case of a recommendation from FSOC, the primary regulator (or regulators) to whom the recommendations are made must either impose the recommended standard within 90 days or explain to FSOC why it is not doing so. *Id*. at § 162(b).

The Federal Reserve has significant, if limited, enforcement authority, which may go beyond just monitoring a SIFI's prudential strength. Although state regulators, not the Federal Government, retain full authority to place insurers in receivership or liquidate them, Dodd-Frank provides that if the Federal Reserve determines that "a condition, practice, or activity" of an insurance SIFI does not comply with existing "regulations or orders" or may pose a "threat to the financial stability of the United States" it can recommend that the functional regulator (i.e. the state insurance regulator with jurisdiction) take action. *Id*. If the functional regulator does not take action within 60 days, the Federal Reserve may take the recommended action as though the company were a "subsidiary bank holding company subject to supervision by the Board of Governors." *Id*.

Perhaps most troubling is Dodd-Frank's potential impact on the ability of state insurance regulators to protect an insurer's capital in the case of an insolvency, and on a state regulator's ability to place an insurer in receivership. Dodd-Frank requires the Federal Reserve to establish regulations outlining "specific remedial actions to be taken" in the case of financial distress. *Id*. at § 166(b). This includes designing measures to determine the sufficiency of a company's financial condition such as regulatory capital, liquidity measures, and "other forward looking measures." *Id*. at § 166 (c)(1) & (2). Nonbank SIFIs are required to develop Resolution Plans, subject to review by the Federal Reserve, FDIC, and FSOC, to be used for their "rapid and orderly resolution" in the event of material distress or failure. *Id*. at § 165(d). This may limit the ability of state regulators to use their own statutory resolution authority.

The extensive authority Dodd-Frank granted to the Federal Reserve to regulate SIFIs will likely lead to conflicts between state and federal regulators. Dodd-Frank provides that FSOC may resolve such regulatory disputes. *Id*. at § 119. Under Dodd-Frank one agency can request FSOC intervention in a dispute without the consent of the other. *Id*. at § 119(a). It is easy to imagine a situation where the Federal Reserve might want to ask FSOC to resolve a dispute regarding an insurance regulatory issue between state and federal regulators. But since the Federal Reserve is a voting member of FSOC and state insurance regulators have no voting representation on that body, it is doubtful whether state insurance regulators would get a fair shake in that forum. Moreover it is not clear what impact the FSOCs' recommendations would have, as Dodd-Frank provides that "any recommendations . . . shall not be binding on the Federal agencies." And it is even questionable whether the FSOC determination would be binding on state regulators. *Id*. at § 119(d).

Exception 2: State Laws That Run Counter to "Covered" International Agreements. Dodd-Frank gives the Federal Insurance Office broad authority over international insurance activities. The FIO is empowered "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (IAIS) and assisting the [Treasury] Secretary in negotiating covered agreements." *Id*. at § 313(c)(1) (E). But that authority is to "coordinate" and "represent," not to regulate. *Id*. The states remain the regulators of the business of insurance, even international insurance. That is, the Massachusetts State Insurance Department is still the primary regulator of an insurance company based in Massachusetts, even if that company operates throughout the world.

There is an exception, however: The FIO can preempt a state insurance measure "to the extent that the Director determines … that the measure (A) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States insurer domiciled, licensed, or otherwise admitted in that State; and (B) is inconsistent with a covered agreement." *Id*. at § 313(f).

That is a very small exception, and extremely complicated to use. The definition of a "covered agreement" is quite narrow. A "covered agreement" is a "bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the protection achieved under State insurance or reinsurance regulation." *Id.* at § 313(r)(2). Note, however, that the definition does not require that the agreement be with another sovereign nation; it could be an agreement between the U.S. Treasury and some non-U.S. regulatory authority.

Before even making a determination that a provision of a state's law is inconsistent with a covered agreement, the FIO must provide notice and consult with the state whose law the FIO believes is inconsistent and with the U.S. Trade Representative. The FIO then must publish notice in the Federal Register of the inconsistency and intent to preempt, citing the specific state insurance measure at issue and the covered agreement it is inconsistent with, and allow time for public comment. If, after consideration of the comments received, the FIO still believes there is an inconsistency with a covered agreement it must issue a Notice of Inconsistency and allow the impacted state or states an opportunity to fix the problem. The FIO must also notify the House Committees on Financial Services and on Ways and Means and the Senate Banking

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Committee before the preemption can become effective.

Despite the difficulty and limitations of this process, the FIO has made clear that it intends to use that authority. In its recently released report on *"How to Modernize and Improve the System of Insurance Regulation in the United States*,"[3] the FIO proposes that: "To afford nationally uniform treatment of reinsurers, FIO recommends that Treasury and the United States Trade Representative pursue a covered agreement for reinsurance collateral requirements based on the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Regulation." FIO Report at 37.

Although designed specifically for the reinsurance collateral problem, the "covered agreement" exception in Dodd-Frank is not limited to that subject. Could the same authority be used by the FIO to preempt state laws in other areas where they are inconsistent with each other or with developing international standards? Could the FIO, for example, use this authority to enter into a covered agreement regarding international standards of solvency for insurers, thus enabling the FIO to preempt state laws that used different standards? That could upend state insurance regulation as it has existed over the past 150 years.

Exception 3: The International Role of the FIO. In addition to the two specific exceptions described above, the FIO may be able to significantly influence state regulation through its international activities. The FIO has taken an active role in the International Association of Insurance Supervisors (IAIS). The IAIS is an international standards-setting organization with a self-defined mission of "promot[ing] effective and globally consistent supervision of the insurance industry."[4] FIO Director Michael McRaith serves on the Executive, Financial Stability, and Technical Committees of the IAIS and chairs the Technical Committee. Through these committee positions FIO is involved in the IAIS' process for developing a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) and Global Insurance Capital Standards.

The statutory authority of the FIO to speak for the U.S. on international matters is less than crystal clear. That has led to significant friction between the FIO and the NAIC, which is a standard-setting organization made up of the U.S. state insurance regulators. While under Dodd-Frank § 313(c)(1)(G), FIO may "develop policies" on prudential aspects of international insurance matters, it must also "consult with the States (including State insurance regulators)." Dodd-Frank authorizes the FIO to "represent[] the United States in the International Association of Insurance Supervisors [(IAIS)]," but FIO is limited to "appropriate" activities at the IAIS. The term "appropriate" is not defined or explained. *Id*. at § 313(c)(1)(E).

Conclusion. Congress designed the Dodd-Frank Act to establish enhanced standards for the solvency and regulation of large multinational financial institutions, with the goal of preventing or ameliorating any future financial meltdown like the one the world has just gone through. Insurance is a small part of the overall scheme (as it was a small part of the recent financial crisis), but nevertheless, Dodd-Frank has given unprecedented authority to the Federal Government to monitor the business of insurance. Vigorous opposition to an expanded Federal role in insurance regulation led to very restrictive language in the Act on the authority given to Federal agencies. Yet Federal officials now have specific regulatory power in the three areas described above, power that, if used effectively, could over time weaken state authority over the business of insurance and change the paradigm for insurance regulation in the United States.

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[3] Federal Insurance Office, U.S. Dept. of the Treasury, How to Modernize and Improve the System of Insurance Regulation in the United States (2013) *available at* http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.

[4] International Association of Insurance Supervisors*, About the IAIS, IAISweb.org* Available at *http://www.iaisweb.org/About-the-IAIS-28* (Last visited on Jan. 26, 2014).

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