Federal Insurance Office Issues Recommendations for the Modernization and Improvement of Insurance Regulation

January 2, 2014

On December 12, 2013, the Federal Insurance Office of the U.S. Department of the Treasury ("FIO") released "How to Modernize and Improve the System of Insurance Regulation in the United States" (the "Report"), a report required by Section 502 of the Dodd-Frank Act. Dodd-Frank created the FIO and gave it the authority to monitor aspects of the insurance industry, identify issues or gaps in regulation that could have financial stability consequences, recommend to the Financial Stability Oversight Council that it designate an insurer as a nonbank financial company supervised by the Federal Reserve and represent the U.S. government in prudential aspects of international insurance matters, among other powers.

The Report is a broad survey of U.S. insurance regulation, covering topics from prudential regulation to consumer protection. It identifies two types of improvements that should be made in the near term:

- direct federal involvement in (i) creating a centralized multi-state license for insurance agents and brokers that would preempt state licensing laws, (ii) regulating mortgage insurance, and (iii) other limited areas; and

- greater uniformity among state regulations.

This memorandum briefly discusses the Report's most significant recommendations, many of which would, if implemented, reduce compliance burdens for insurers by reducing inconsistent and duplicative state regulations.

A. FEDERAL INVOLVEMENT

The Report recommends certain limited areas for direct federal involvement in the near term:

- *Agent and Broker Licensing* — Insurance agents and brokers are licensed at the state level and are subject to varying requirements in different states, resulting in barriers to doing business in multiple states with little consumer benefit. The Report recommends that Congress pass the National Association of Registered Agents and Brokers Reform Act of 2013, legislation that has passed in the House and is pending in the Senate, which would create a body tasked with developing uniform licensing requirements.

- *Mortgage Insurance* — Mortgage insurers provide credit enhancement to mortgages guaranteed by government-sponsored enterprises (GSEs). Three of the eight U.S.

mortgage insurers failed during the housing crisis of 2007-2009. The GSEs and just 16 states have regulations specific to mortgage insurers, and during the housing crisis, these regulations were waived or relaxed when insurers were no longer able to comply. The Report recommends the adoption of robust national solvency and business practice standards, without providing specifics.

- *Recognition of Foreign Reinsurance* — State regulations allow insurers who transfer risk to U.S.-based reinsurers to receive 100% credit on their financial statements for ceded liabilities. However, regulations typically require foreign reinsurers to post qualifying collateral in order for ceding insurers to receive 100% credit. The amount and quality of collateral varies among the states, depending on factors such as the creditworthiness of the reinsurer and the perceived strength of the reinsurer's home-country regulation, both of which are assessed at the discretion of the state regulator. Without providing specifics, the Report recommends that the FIO and the United States Trade Representative negotiate and enter into agreements with foreign governments and/or regulators relating to the recognition of reinsurance prudential regulation. The Report also recommends that the FIO, rather than the states, determine whether a foreign country has sufficiently effective regulation of reinsurance.

- *Group Supervision* — State regulators supervise insurers at an entity-specific level and lack the power to regulate or request certain important information relating to affiliated entities operating and domiciled outside the state. This prevents any particular regulator from supervising the overall operations of a multi-jurisdictional firm. The Report recommends the FIO create supervisory "colleges" for insurance groups that would consist of every functional regulator of an insurance group, including international regulators, as well as the FIO itself. The colleges would be a forum for regulators to meet and identify regulatory gaps and potential weaknesses of the group.

- *Nonadmitted Insurance Tax* — Surplus lines insurance brokers provide insurance by an insurer not admitted to engage in the business of insurance in a particular state. The Nonadmitted and Reinsurance Reform Act, a part of Dodd-Frank, prohibits any state other than the home state of an insured from taxing surplus lines policies, and permits states to enter into agreements to allocate premium taxes among the states in which coverage is actually provided. To date, states have not achieved consensus on whether and how to allocate premium taxes on nonadmitted insurance. The FIO will monitor progress on the issue and warns that further federal action may be necessary.

- *Rate Regulation* — The FIO will monitor different approaches to rate regulation in the states to help identify best practices.

- *Access to Insurance* — The FIO will monitor state insurance activity to improve the accessibility and affordability of insurance by minority communities, particularly Native Americans, and will review whether certain factors that determine a consumer's insurability, such as marital status and creditworthiness, should factor into insurers' underwriting standards. The FIO will also work with regulators to develop personal auto insurance policies for U.S. military personnel that are enforceable across state lines.

In addition to these topics, the Report notes that a forthcoming report by the FIO will provide a policy analysis of issues involved with insuring natural catastrophes.

B. STATE UNIFORMITY

The Report notes that a lack of uniformity in state regulation subjects insurers operating nationally in the U.S. to significantly higher compliance costs compared to insurers operating solely abroad, creates safety and soundness concerns because no one regulator is responsible for oversight of large, complex institutions and because of regulatory arbitrage, and impedes cooperation with international regulatory bodies. Accordingly, the Report identifies several areas in which states should harmonize their regulations:

- *Solvency Standards* — The Report notes that some state regulators have made certain discretionary decisions affecting solvency oversight, including permitting deviations from risk-based capital requirements and standard accounting practices set forth by the National Association of Insurance Commissioners ("NAIC") for certain types of insurers (e.g., monoline insurers and fraternal benefit societies operating as life insurers). The Report recommends that state regulators develop a process whereby before implementing a discretionary practice involving important solvency matters, a state regulator must notify and obtain the consent of regulators from other states in which the insurer operates. Additionally, the Report notes that current risk-based capital standards are not tailored to the risks of different types of institutions, and should be revised to integrate best practices developed through international consensus.

- *Reserves* — Reserves are currently calculated based on a standardized NAIC model law that is not tailored to the specific risks of different types of institutions. Regulators have considered moving toward principles-based reserving ("PBR"), which would rely on an insurer's internal risk modeling, including the insurer's experience with specific portfolios or products. While some regulators support a revised model law that would govern PBR, implementation of the revisions requires a supermajority of state legislatures to adopt the revisions. The Report recommends adoption of PBR.

- *Enforcement of Market Conduct Regulation* — The Report recommends that states coordinate their efforts and defer to "lead" regulators in multi-state market conduct examinations.

- *Receivership* — State receivership laws vary significantly, including in their treatment of derivatives and other qualified financial contracts ("QFCs"). While federal bankruptcy law and FDIC receivership law (with respect to depository institutions) both exempt QFCs from the automatic stay, thus allowing QFC counterparties to close out their positions with an insolvent entity, only some state insurance receivership laws do so. The Report recommends a uniform approach to QFC treatment. The Report also notes that financial reports of failed institutions vary in their level of detail and accounting treatment, and recommends that states should adopt uniform standards for disclosure.

- *Reinsurance Captives* — Commercial insurers have increasingly formed and transferred risk to captive reinsurance vehicles to reduce reserve obligations and free up capital of the primary insurers. However, certain states that have competed to be the domestic regulators of reinsurance captives do not impose rigorous or consistent capital rules on the reinsurance entities. The Report recommends uniform, robust and transparent oversight of reinsurance captives, including the development of a uniform capital requirement and a prohibition on transactions that do not constitute a legitimate transfer of risk to the reinsurance captives.

- *Product Approval* — A number of states participate in the Interstate Insurance Product Regulatory Commission ("IIPRC"), an organization that offers standards and a centralized approval process for new insurance products in the areas of life insurance, annuity, disability income, and long-term care. However, uniformity in product approval has not been achieved because (1) several states, including New York, California and Florida have not joined the IIPRC scheme, (2) the number of product lines eligible for IIPRC review is limited, and does not include group plans and (3) insurers may opt-out of IIPRC review, allowing them to submit contracts for approval to the less stringent of IIPRC and state review. To fix these problems, the Report recommends that: (1) non-participating states join the IIPRC, (2) the IIRPC expand its product coverage and (3) IIPRC standards serve as a floor, and not an alternative, to state product approval standards.

- *Guaranty Fund Pay-outs* — Insurers contribute to state guaranty funds that protect policyholders in the event of insurer insolvency. The Report recommends that guaranty funds adopt identical maximum pay-outs for similar types of policies.

- *Sale of Annuities* — The Report recommends that states adopt the NAIC's model regulation governing annuity sales, which consists of standards designed to ensure that annuity products are suitable for the consumers that purchase them.

- *Corporate Governance* — The Report recommends that the NAIC propose, and states adopt, model laws relating to corporate governance, including standards of fitness for insurers' officers and directors.

While the Report does not recommend full federal regulation of insurance, it warns that should states fail to reform particular areas of regulation in the near term, Congress should "strongly consider" direct federal involvement to fill those regulatory gaps, by the federal government serving as either a coordinating body (and possibly preempting state law that fails to conform to uniform standards) or direct regulator of select aspects of the industry, such as large complex institutions or institutions that seek a federal charter.

* * *

For more information about the Report, please contact a member of Simpson Thacher's Insurance or Financial Institutions groups.

Gary Horowitz (212) 455-7113 ghorowitz@stblaw.com	Peter Gordon (212) 455-2605 pgordon@stblaw.com
Steven DeLott (212) 455-3426 sdelott@stblaw.com	Randy Benjenk (212) 455-2307 randy.benjenk@stblaw.com

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state or local tax law. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000