

Dodd-Frank Act: Impact on Insurance Sector

July 21, 2010

Today the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. While the insurance industry, and its regulators, largely escaped much of the blame for the financial crisis – and the banking industry is clearly the focus of this legislation – the insurance industry is not completely exempted from many of the legislation's major reforms. While the bill does not make any dramatic changes to the state-based system of insurance regulation, federal oversight over insurers will increase as federal regulators seek to look more broadly at the financial services industry.

Insurance-Specific Reforms

The financial reform bill includes an historic, though limited, expansion of the federal presence in insurance oversight. Title V includes two major insurance components: (1) the creation of a Federal Insurance Office within the Treasury Department with authority to preempt state measures inconsistent with international agreements; and (2) the streamlining of state-level surplus lines and reinsurance regulation.

Federal Insurance Office

The legislation creates a Federal Insurance Office ("FIO") to be housed within the Department of the Treasury, to be headed by a Director appointed by the Treasury Secretary. The FIO is intended, in part, to remedy the current lack of insurance expertise at the federal level. The scope of FIO's oversight extends to all lines of insurance except health insurance, long-term care insurance,¹ and federal crop insurance. The authority granted to FIO is well short of a regulatory role. There is no federal chartering component to the legislation, and its preemption authority (see below) is limited.

Industry Oversight

The FIO is tasked with monitoring the insurance industry and gathering information, 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." It is empowered to gather information from the insurance industry in order to analyze such data and issue reports. An annual report to Congress on the insurance industry is required. In gathering information, the FIO has fairly broad authority and

¹ To the extent that long-term care insurance includes an annuity component, FIO will be empowered to oversee it.

may require insurers (and their affiliates) to submit data, and the FIO Director is empowered to issue subpoenas to gain such information. On the other hand, the legislation requires FIO to obtain data from Federal and state regulatory agencies or publicly available sources, if possible, before requiring insurers to submit such data. Additionally, the legislation includes an exemption for small insurers from the requirement to submit information.

At present, the legislation leaves FIO with a largely free hand in determining the subject matter of the annual reports on the industry it will prepare. Two other reports, however, are specifically required: (1) a study on the modernization of insurance regulation in the U.S., required within 18 months of the date of enactment; and (2) a report on the U.S. and global reinsurance market.

International Agreements & State Law Preemption

The most substantial authority granted FIO is in the area of international agreements. Under the legislation, the Treasury Secretary and U.S. Trade Representative are jointly authorized to enter into agreements with foreign governments relating to the recognition of prudential measures with respect to the business of insurance or reinsurance. In implementing such agreements, the FIO will have the authority to preempt state law if it is determined that the state law is inconsistent with the international agreement and treats a non-US insurer less favorably than a US insurer.

This authority is limited in several respects, however. First, the scope of agreements that can be negotiated is limited to those that relate to the recognition of prudential measures, and must achieve a "substantially equivalent" level of protection for consumers. Second, the authority is limited by a series of savings provisions, which restrict preemption to matters not affecting rates, premiums, underwriting or sales practices, coverage requirements, and the application of state antitrust laws to the business of insurance. Lastly, determinations by the FIO that a state law is inconsistent with an international agreement are subject to *de novo* review – meaning the FIO's determinations will not be accorded deference by the courts.

Despite the limitations, this authority provides a mechanism for streamlining implementation of international insurance regulatory agreements. In particular, the legislative history of the statute suggests that Congress intends this authority to be used to resolve the dispute over state-level reinsurance collateral requirements. Such a resolution is not, however, compelled by the legislation and will depend upon an agreement being reached between the U.S. and its foreign counterparts.

Other Duties

- The FIO is authorized to recommend to the Financial Stability Oversight Council that it designate an insurer as a systemically significant entity requiring additional supervision by the Federal Reserve. The FIO Director will serve in a non-voting, advisory capacity on the Council.
- The current Terrorism Risk Insurance Program Office within Treasury, which oversees the Terrorism Risk Insurance Act, will be transferred to the FIO.
- The FIO is also tasked with monitoring the extent to which underserved communities and consumers have access to affordable insurance products.

Surplus Lines and Reinsurance Regulation

Title V of the Dodd-Frank bill also includes, as a separate subtitle, the Nonadmitted and Reinsurance Reform Act ("NRRA"), which was originally introduced in 2006 to eliminate regulatory inefficiencies associated with surplus lines insurance and reinsurance. The NRRA is comprised of two parts – one dealing with surplus lines regulation and another title dealing with reinsurance.

Surplus Lines

The surplus lines part provides that the home state of the insured will have exclusive authority to regulate the placement of nonadmitted insurance. Only the insured's home state will be permitted to collect premium taxes on nonadmitted insurance, and the legislation establishes a uniform system for allocation of premium tax obligations through an interstate compact or other procedures established by the states.

The NRRA would also establish uniform standards for surplus lines eligibility criteria by requiring that the capital and surplus requirements for U.S.-domiciled insurers conform to those in the NAIC's Nonadmitted Insurance Model Act. Additionally, states may not prohibit surplus lines brokers from doing business with nonadmitted insurers listed on the *Quarterly Listing of Alien Insurers* maintained by the NAIC's International Insurance Division. In effect, therefore, any IID-listed insurer will have trading privileges throughout the United States without having to be separately listed by any state.

Finally, the surplus lines part would preempt state diligent search requirements for certain sophisticated commercial purchasers, provided the surplus lines broker has disclosed to the purchaser that such

insurance may be available on the admitted market, and the purchaser has requested nonadmitted placement in writing.

Reinsurance

NRRA's reinsurance part provides that a ceding insurer's state of domicile will be the single point of regulation with respect to credit for reinsurance, provided that state is NAIC-accredited or has financial solvency requirements substantially similar to those required for NAIC-accreditation. It also provides that the ceding insurer's state of domicile will be the single point of regulation for purposes of (a) the rights of the parties to provide for dispute resolution through arbitration agreements, (b) choice of law, and (c) imposition of standard terms different than those in the reinsurance contract. Finally, the reinsurance part provides that a reinsurer's state of domicile will be solely responsible for regulating the reinsurer's solvency, provided it is an NAIC-accredited state. Other states are prohibited from requiring any financial information other than what the domiciliary state requires.

Other Matters Impacting Insurance

As noted above, many of the provisions in this legislation are focused on the banking industry rather than insurance; however, there remain areas where insurers are or could be impacted. What follows is by no means an exhaustive list or a detailed discussion, so if you have specific questions in these areas please contact us. With those caveats, we note the following:

- *Systemic Risk.* Insurers could potentially be determined by a newly-created Financial Stability Oversight Council to present systemic risk to the financial system and thus be supervised by the Federal Reserve. Such supervision would subject such insurers to prudential standards, if the Council determines that financial distress at the company would pose a threat to the US financial system.
- *Orderly Liquidation.* The legislation provides an "Orderly Liquidation Authority" mechanism whereby the FDIC would have enhanced powers to resolve distress at financial institutions. Insurance holding companies and any non-insurance subsidiaries of insurers may be subject to this authority. Insurance companies are generally exempt from the liquidation authority, but the FDIC would have "backup authority" to place an insurance company into orderly liquidation under state law if the state regulator has not done so within 60 days of a systemic risk determination.
- *Liquidation Fund Assessments.* The bill creates an Orderly Liquidation Fund to help fund the cost of resolving a failing

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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financial firm, which would be funded by assessments on large financial companies – including, potentially, insurers. The size of an entity appears to be the key determination as to the amount of any assessment, but other non-size risk factors are supposed to be taken into consideration. For insurers, contributions to state guaranty funds must be considered.

- *Derivatives.* The bill would require most standardized derivatives to be routed through clearinghouses and traded on exchanges. The legislation would create two new classes of regulated entities, swap dealers and "major swap participants" which would be required to register with the SEC and/or the CFTC and would be subject to margin, capital, record-keeping and business conduct requirements. While the legislation makes clear that "swaps" are not insurance and may not be regulated as such under State insurance law, it is not entirely clear whether insurers could be determined to be "major swap participants." Please see our more detailed discussion of the Derivatives title of the bill, which includes a specific discussion relating to insurers, [here](#).
- *Bureau of Consumer Financial Protection.* One of the more high-profile provisions of the bill is that which creates a new federal-level entity within the Federal Reserve with authority to regulate the types of financial products offered to consumers. Insurance products are specifically exempted from this bureau's authority; however, this exemption is worth monitoring as the new entity gets formed and begins to issue implementing regulations.

Outlook

Major work remains – and many policy questions are yet to be resolved – as the various federal agencies will need to implement the various reforms through rulemakings and other processes. Also, of course, the newly-created FIO will need to be formed and staffed. We are already engaged in preliminary discussions about the implementation of this measure as it relates to the insurance industry, and we expect to be highly involved in this process. As always, we will keep you updated as developments warrant.

You may find more information about the Act in our Client Alert distributed on July 2, 2010, located [here](#).

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