

**THE “MODERNIZATION” OF THE REGULATION OF
FINANCIAL SERVICES COMPANIES: THE IMPLICATIONS
FOR THE REINSURANCE INDUSTRY**

**By Roland Goss
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There has been a great deal written and said about the perceived inadequacies of the regulation of various aspects of the financial services industry, and the extent to which problems in that industry have contributed to the current economic situation. Many suggestions have been put forward by different constituencies for the “modernization” of the regulation of various aspects of the financial services industry. Little is being written, however, about the potential impact of the suggested regulatory reforms on the insurance and reinsurance industries. Those who believe that the impact on these industries of the proposed regulatory changes will be limited to a relatively small number of companies opting for an optional federal charter or incorporation may be in for quite a surprise. Many of these proposals are still at a conceptual stage, although some are now progressing to proposed legislation or proposed regulations. Due to the preliminary nature of these proposals, an in-depth analysis is not worthwhile at this time, but it is useful to appreciate the areas in which proposals are being made which may affect the reinsurance industry. Four examples demonstrate the potential impacts upon the reinsurance industry.

The NAIC’s Proposed Regulatory Modernization and Reinsurance Collateral Regulation

Several years ago, based in part upon regulatory activity in the European Union to use the financial strength of reinsurance companies as a basis for regulation, and alleged discrimination in the regulation of US and foreign domiciled reinsurers, the NAIC began considering changing the requirements for the posting of collateral for reinsurance transactions so that such requirements would be based upon the financial strength of the reinsurers. In approximately March 2007, this effort expanded into consideration of “modernizing” the regulation of reinsurance companies by providing for a single state regulator for both US and foreign domiciled reinsurers.

Although the NAIC has traditionally implemented its regulatory proposals through model acts and model regulations adopted by the states, it has developed a proposed federal bill as the way to implement the basic modernization framework.¹ The NAIC’s Reinsurance Regulatory

¹ This bill may be found in the blog post for this SPECIAL FOCUS item, and at http://www.naic.org/documents/committees_e_reinsurance_fed_legislation_draft.pdf.

Modernization Act of 2009 has not yet been introduced into Congress. It provides a regulatory structure which is overseen by a nonprofit corporation - the Reinsurance Supervision Review Board - “owned by or affiliated with the NAIC,” the Board of Directors of which is composed of state insurance commissioners. This proposed bill has been exposed for comment by the NAIC’s Reinsurance Task Force through April 23, 2009. This proposal provides that the state which is the designated regulator for each reinsurance company would be responsible for setting the financial rating of the company and implementing collateral requirements for reinsurance transactions. Additional detail on the context and provisions of this bill are available in a separate document linked to the blog post for this document.

Proposed Federal Legislation

Reinsurance Companies and Reinsurance Collateral

The NAIC’s shift to the federal stage may have been prompted, at least in part, by the inclusion of similar regulation in some of the conceptual proposals for federal “modernization” of the regulation of financial companies, i.e., the NAIC is moving to protect its turf. One of the earliest documents setting forth principles and concepts for the “modernization” of the regulation of the financial services industry is “The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure” (March 2008) (“the Treasury Blueprint”).² The Treasury Blueprint calls for the establishment of an “Office of Insurance Oversight” (“the OIO”) within the Department of the Treasury, one of the purposes of which would be

to address international regulatory issues, such as reinsurance collateral. Therefore, the OIO would become the lead regulatory voice in the promotion of international insurance regulatory policy for the United States (in consultation with the NAIC), and it would be granted the authority to recognize international regulatory bodies for specific insurance purposes. The OIO would also have authority to ensure that the NAIC and state insurance regulators achieved the uniform implementation of the declared U.S. international insurance policy goals.³

Under this proposal, the federal government would be the driving force behind the regulation of reinsurance collateral, with the NAIC and the states being relegated to implementing such proposals. It is not clear what prompted the Treasury to place the issue of reinsurance collateral in a prominent position in the Treasury Blueprint, since this issue has not

² The Treasury Blueprint may be found in the blog post for this SPECIAL FOCUS item, and at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

³ Treasury Blueprint at 11.

been identified as having contributed to the current economic problems. Nevertheless, it is there.

Systemic Risk

Many have suggested that the current economic difficulties resulted, at least in part, from “systemic risks” in the economy, which were unregulated. Systemic risks are generally considered to be risks from unregulated industries or unregulated transactions occurring in regulated industries, including for example credit default swaps and sub-prime loans. The “solution” for such problems is said to be the regulation of such systemic risks in the public interest. Although one might think that the majority of the “systemic risks” that contributed to our current economic problems were in the areas of lending and securities, some proposals include the insurance industry within the scope of these problems, even though insurance transactions, and insurance companies, have been heavily regulated by the states for many years. The bail-out of AIG is pointed to by some as evidence of a need for additional regulation in the insurance industry, even though it is frequently pointed out that AIG’s financial problems arose out of its non-insurance operations.

Historically, the proposal for a national “charter” for insurance companies has been proposed as an option for federal regulation of a portion of the insurance industry, with companies having the option to elect a federal charter or remain with their state law incorporation.⁴ Nevertheless, a recently introduced bill, HR 1880,⁵ provides the following with respect to systemic risks and the insurance industry:

All insurance commissioners (state and national) would be required to share information with a Systemic Risk Regulator, as defined by the Administration. The Systemic Risk Regulator shall make corrective action recommendations to the Commissioner or state commissioner to take action to mitigate or avoid actions taken by an insurer or affiliate that would have serious adverse effects on economic conditions and financial stability. If action is not taken, the Systemic Risk Regulator with approval of the Coordinating Council for Financial Regulators to circumvent the insurance regulator in emergency circumstances. Finally, if the systemic risk regulator in consultation with the National Insurance

⁴ The extent to which federally chartered insurers would be regulated is unclear. It is possible that federal regulation would be less complete and less comprehensive than the existing state regulation.

⁵ HR 1880 may be found in the blog post for this SPECIAL FOCUS item, and at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1880ih.txt.pdf.

Commissioner determines an insurer is systemically important they can require the insurer to be nationally chartered.

HR 1880 Fact Sheet.⁶

Under this proposal, insurance companies which might have “serious adverse effects on economic conditions and financial stability” may have to be federally regulated. So much for an “optional” federal insurance charter. While it is not clear what systemic risks there may be in the reinsurance industry, given the practical role of reinsurance is safeguarding the capital and financial health of insurance companies, the reinsurance industry may incur either direct or indirect impacts from the systemic regulation of insurers.

Federal Solvency Regulation

The near collapse of AIG has prompted consideration of proposals for the federal government to more closely monitor the financial health of large financial service companies, partly based upon the assumption that if they are “too big to fail,” the government should monitor their financial health sooner, rather than later, to attempt to avoid the shock of near failures. The Treasury has floated a draft bill titled the “Resolution Authority for Systematically Significant Financial Companies Act of 2009”⁷ which would extend the “systemic regulation” authority of the FDIC (or some other federal agency) to insurance holding companies. This regulation would extend to all aspects of the operation and financial solvency of such companies. Although this bill does not apply such regulation to insurance companies themselves, it does not take much imagination to foresee such detailed regulation of insurance holding companies having a substantial impact upon the well-established regulation of the solvency of insurance companies by the states, or upon the regulation of business practices and transactions which may have a significant effect upon the financial health of such companies. Any fundamental change in the regulation of the solvency of insurance companies is likely to have a significant impact on the reinsurance industry.

⁶ Less mature are general proposals for the establishment of a federal insurance regulator or a federal insurance office. The proposed duties of this official or office are as yet undeveloped, but could be expansive. The HR 1880 fact sheet may be found in the blog post for this SPECIAL FOCUS item, and at http://www.house.gov/apps/list/press/il08_bean/National_Insurance_Consumer_Protection_Act_Fact_Sheet.pdf.

⁷ This proposed bill may be found in the blog post for this SPECIAL FOCUS item, and at <http://www.ustreas.gov/press/releases/reports/032509%20legislation.pdf>.

This article does not constitute legal or other professional advice or service by JORDEN BURT LLP and/or its attorneys.

For additional information:

This is the initial post of what will no doubt be a series of special posts regarding the proposals for the federal “modernization” of the regulation of the reinsurance and insurance industries. Jordan Burt has formed a special Task Force to monitor these proposals. Although Reinsurance Focus will track such proposals periodically, to obtain more frequent and complete updates on the particular proposals that might have an impact on the reinsurance industry, contact blogmaster and Task Force Chair Roland Goss (rcg@jordenusa.com or (202) 965-8148).