Federal Reform Bill and the Insurance Industry

by David Sherwood

Dodd-Frank – Impact on insurers now and in the future

> *"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Sir Winston Churchill, November 1942.*

This affects you

The new Dodd-Frank Act (Dodd-Frank) or the (Act) signed into law on July 21, 2010, is a significant and complex piece of legislation, containing more rules than Sarbanes Oxley, which has been compared to Gramm-Leach-Bliley as one of the more sweeping public policy reform packages affecting the financial services sector since the Glass-Steagall Act 1933. An outside observer may argue that, relative to banking, the insurance sector was not heavily impacted by the financial crisis and that the Act leaves the insurance industry breathing a collective sigh of relief.

What are some of the reasons why the financial services sector may be overlooking insurance in the short term?

- **Misperception of how insurance companies work**—A common perception is the insurance sector is very different from the banking and securities sectors for which the majority of the Dodd Frank reform was focused. Issues in the insurance sector have often arisen from the liabilities side of the balance sheet. For example, products with embedded guarantees/options are often based on assumptions that are not always correctly anticipated or insured liabilities may not emerge for many years after the event. Unlike many of the issues impacting the banking and securities sectors, issues impacting insurance companies can take many years to manifest.
- **A belief that the Act was not aimed at insurance companies**—the relative lack of specific mention of Insurers in the Act relative to other financial services sectors, with some notable exceptions, can lead the reader to believe that it is intended for "other" financial services sectors. For example, the Consumer Financial Protection Bureau does not cover insurance products. In addition, the public policy issue of an "optional federal charter" was not heavily debated in Congress due to other pressing financial services' legislative issues.
- **Misperception that insurance companies were not engaged in the activities covered by Dodd Frank**—certainly in terms of specificity, the sector is a clear second; but there are many ground-setting measures put in place by the Act that may not seem immediately evident. It is not uncommon to find an insurance company with other financial services interests such as a thrift or broker dealer; therefore, insurers with ancillary activities are dealing with implications of Dodd-Frank in a number of different business areas as well as those parts of the Act that deal with insurers directly.
- **Primacy of state regulation**—in the majority of cases, insurance companies are state regulated and not federally regulated. The regulatory framework for insurers is currently dominated by the primacy right of the state.
- **Misperception that insurance companies are less impacted by changing global regulation**—in relation to their position as being deemed systemically risky.

The beginning of a long journey

The reality is that Dodd-Frank provides a mechanism for potential federal and further state regulation of insurance companies. Title V of the Dodd Frank Act establishes the

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Federal Insurance Office (FIO) within the Treasury. At this stage the FIO's powers are limited and it will act in more of an advisory capacity.

FIO will have responsibility for all forms of insurance other than health insurance, certain long-term care insurance and crop insurance and, among other things, the authority to:

- recommend insurers to the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve as systemically risky nonbank financial companies;
- monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation that could contribute to a systemic crisis in the insurance industry or the 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;
- coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters;
- coordinate with the states on matters of national and international importance, and determine whether state insurance measures are preempted by certain international insurance agreements; and
- advise the Secretary of the Treasury on major domestic and international policy and prudential insurance issues.

Dodd Frank will impact some activities of an insurance company in a number of ways.

- An insurer that owns thrift will face the challenge of a change in regulators from the Office of Thrift Supervision (OTS) to the Office of the Comptroller of the Currency (OCC). This will also entail the thrift holding company being regulated by the Federal Reserve Board (FRB) even if this is an insurer.
- The Volker Rule prohibits a banking entity defined as insured banks or thrifts, or company that controls an insured bank of thrift from undertaking proprietary trading activities and limited investments in private equity, hedge funds and other private pools of capital. While insurance companies were able to gain certain exemptions from their own activities, this did not apply to the activities of any bank or thrift that they may own.
- Registration of advisors to private pools of capital would impact insurance companies to the extent they act as advisors in asset management functions. There are certain thresholds; however, generally funds with assets under management of greater than $100 million would be required to register with the SEC if not already registered.
- A provision in the Act that may impact insurers is the SEC ruling that would cause the move to a fiduciary standard for retail broker dealers and registered security products (variable life and variable annuities). The SEC is tasked with completing a study on this issue and making recommendations for implementation.
- New capital requirements to address systemic risks will affect insurers who are deemed systemically important nonbank financial companies.
- Lastly, Dodd-Frank includes many governance reforms for publicly traded companies addressing executive compensation, proxy access, risk committees and investor protections.

Further regulation to come?

Perhaps one of the most interesting aspects is the requirement of the FIO that within 18 months of enactment, the

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office director must conduct a study and submit a report to Congress, which includes recommendations on steps to modernize and improve regulation of the insurance industry giving consideration to:

- systemic risk;
- capital and liquidity standards;
- consumer protection, including gaps in state coverage;
- national uniformity of state coverage;
- consolidated supervision;
- international coordination; and
- factors associated with federal regulation.

Government studies are may be a precursor to future legislative changes.

In reading Dodd-Frank you may conclude that the insurance sector was not heavily impacted by the Act but as the saying goes, "the devil is in the details." Depending on the structure of a particular insurance company, several provisions could be applicable.

One question to be asked today is, "what's next"? Dodd-Frank laid the framework for the creation of the Federal Insurance Office and potentially further regulatory reform. As the 112th Congress convenes in January 2011, and as reports, studies and the rulemaking process move ahead, what-next clarity may be forthcoming and if so will need to be understood in the marketplace.

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